S. HRG. 98-332—PT. 4

# ADMINISTRATION'S FISCAL YEAR 1984 BUDGET PROPOSALS—II

## HEARINGS

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

JUNE 15, 16, 22, 23, 28, AND 29, 1983

PART 4 OF 4
(June 28 and 29, 1983 Tax Expenditures)

Printed for the use of the Committee on Finance

24-865 O

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1983

S361-76

## COMMITTEE ON FINANCE

ROBERT J. DOLE, Kansas, *Chairman*

BOB PACKWOOD, Oregon
WILLIAM V. ROTH, Jr., Delaware
JOHN C. DANFORTH, Missouri
JOHN H. CHAFEE, Rhode Island
JOHN HEINZ, Pennsylvania
MALCOLM WALLOP, Wyoming
DAVID DURENBERGER, Minnesota
WILLIAM L. ARMSTRONG, Colorado
STEVEN D. SYMMS, Idaho
CHARLES E. GRASSLEY, Iowa

RUSSELL B. LONG, Louisiana
LLOYD BENTSEN, Texas
SPARK M. MATSUNAGA, Hawaii
DANIEL PATRICK MOYNIHAN, New York
MAX BAUCUS, Montana
DAVID L. BOREN, Oklahoma
BILL BRADLEY, New Jersey
GEORGE J. MITCHELL, Maine
DAVID PRYOR, Arkansas

RODERICK A. DEARMENT, *Chief Counsel and Staff Director*
MICHAEL STERN, *Minority Staff Director*

# CONTENTS

## ADMINISTRATION WITNESSES

Page
Rivlin, Dr. Alice M., Director, Congressional Budget Office ... 19
Rowberg, Dr. Richard, Manager, energy and materials program, Office of Technology Assessment, accompanied by Dr. Richard Thoreson ... 40

## PUBLIC WITNESSES

American Hospital Association, Donald C. Wegmiller, president, Health Center System, Minneapolis, Minn ... 209
American for Capital Formation, Dr. Charls E. Walker, chairman ... 254
Aronsohn, Alan J. B., Esq., tax counsel, National Realty Committee ... 177
Association of Private Pension and Welfare Plans, Edward J. Davey, executive director and general counsel ... 286
Birkmeir, Hon. Willard, mayor, Perkin, Ill ... 47
Carlson, Dr. Jack, executive vice president, National Association of Realtors ... 134
Coalition for Low and Moderate Income Housing, Stephen B. Smith, member, executive committee ... 241
Council of Pollution Control Financing Agencies, Ron Linton, executive director ... 214
Davey, Edward J., executive director and general counsel, Association of Private Pension and Welfare Plans ... 286
Dickinson, Kenneth, D., president, Dickinson, Logan, Todd & Barber, Inc., on behalf of the Mortgage Bankers Association of America ... 231
Employee Benefit Research Institute, Dallas L. Salisbury, executive director ... 273
Environmental Action Foundation, Richard E. Morgan, research coordinator ... 78
Forest Industries Committee on Timber Valuation and Taxation, G. Robin Swift, Jr ... 57
Franasiak, David E., manager, Tax Policy Center, U.S. Chamber of Commerce ... 259
Independent Sector, Brian O'Connell, president ... 51
Institute for Research on the Economics of Taxation, Dr. Norman B. Ture, chairman of the board ... 263
International Council of Shopping Centers, Wallace Woodbury, chairman, tax subcommittee ... 164
Huard, Paul R., vice president, taxation and fiscal policy department, National Association of Manufacturers ... 247
Linton, Ron, executive director, Council of Pollution Control Financing Agencies ... 214
Metzenbaum, Hon. Howard M., a U.S. Senator from Ohio ... 5
Mortgage Bankers Association of America, Kenneth D. Dickinson, president, Dickinson, Logan, Todd & Barber, Inc ... 231
Morgan, Richard E., research coordinator, Environmental Action Foundation ... 78
National Apartment Association, Scott Slesinger, executive vice president ... 238
National Association of Home Builders, David Smith, vice president and secretary ... 140
National Association of Manufacturers, Paul R. Huard, vice president, taxation and fiscal policy ... 247
National Association of Realtors, Dr. Jack Carlson, executive vice president ... 134
National Committee on Small Issue Industrial Development Bonds, Ramsay D. Potts, Esq ... 204
National Realty Committee, Alan J. B. Aronsohn, Esq., tax counsel ... 177
O'Connell, Brian, president, Independent Sector ... 51
Potts, Ramsay D., Esq., National Committee on Small Issue Industrial Development Bonds ... 204

Page
Salisbury, Dallas L., executive director, Employee Benefit Research Institute... 273
Slesinger, Scott, executive vice president, National Apartment Association....... 238
Smith, David, vice president and secretary, National Association of Home Builders...... 140
Smith, Stephen B., member, executive committee, Coalition for Low and Moderate Income Housing...... 241
Swift, G. Robin, Jr., president, Swift Lumber Co...... 57
Ture, Dr. Norman B., chairman of the board, Institute for Research on the Economics of Taxation...... 263
U.S. Chamber of Commerce, David E. Franasiak, manager, Tax Policy Center...... 259
Walker, Dr. Charls E., chairman, American for Capital Formation...... 254
Wegmiller, Donald C., president, Health Central System, Minneapolis, Minn., on behalf of the American Hospital Association...... 209
Woodury, Wallace, chairman, tax subcommittee, International Council of Shopping Centers...... 164

## ADDITIONAL INFORMATION

Committee press release...... 1
Opening statement of Senator Dole...... 1
Letter to Senator Dole from Senators Roth, Symms, Armstrong, Wallop, and Grassley...... 3
Prepared statement of Senator Howard M. Metzenbaum...... 11
Prepared statement of Dr. Alice M. Rivlin and her answers to questions from Senators Dole and Long...... 22, 27, 36
Prepared statement of Dr. Richard E. Rowberg...... 42
Prepared statement of Hon. Willard Birkmeier...... 48
Prepared statement of Brian O'Connell...... 54
Prepared statement and a letter from G. Robin Swift, Jr...... 59
Prepared statement of Richard E. Morgan...... 80, 89
Prepared statement of Dr. Jack Carlson...... 135
Prepared statement of David Smith...... 141
Prepared statement of Wallace Woodbury...... 165
Prepared statement of National Realty Committee...... 178
Opening statement of Senator Dave Durenberger...... 195
Report by Nonna A. Noto and Dennis Zimmerman of the Congressional Research Service...... 197
Prepared statement of Ramsay D. Potts...... 205
Prepared statement of Donald C. Wegmiller...... 210
Prepared statement of Ronald Bean...... 215
Report prepared for the Council of Pollution Control Financing Agencies...... 219
Prepared statement of Kenneth D. Dickinson...... 232
Prepared statement of Scott L. Slesinger...... 239
Prepared statement of Stephen B. Smith...... 242
Prepared statement of Paul R. Huard...... 248
Prepared statement of Charls E. Walker...... 255
Prepared statement of David E. Franasiak...... 260
Prepared statement of Dr. Norman B. Ture...... 264
Prepared statement of Dallas L. Salisbury and Sylvester J. Schieber...... 274
Prepared statement of Edward J. Davey...... 288

## COMMUNICATIONS

Prepared statement of Senator Dan Quayle...... 291
American Petroleum Institute...... 320
Committee for Effective Capital Recover...... 380
Iron Ore Lessors Association, Inc...... 395
The National Association of Life Underwriters...... 400
National Council of Coal Lessors, Inc...... 409
National Governors' Association...... 413
National Multi Housing Council...... 415
National Solid Wastes Disposal Facilities...... 419
National Association of Independent Colleges and Universities...... 426
Retail Tax Committee of Common Interest...... 432
Southeastern Lumber Manufacturers Association...... 441
The Tax Council...... 443
American Hotel and Motel Association...... 471

# ADMINISTRATION'S FISCAL YEAR 1984 BUDGET PROPOSALS—II

---

TUESDAY, JUNE 28, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washinton, D.C.*

The committee met, pursuant to notice, at 10:03 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Danforth, Long, Moynihan, and Bradley.

Also present: Senator Metzenbaum.

[The press release announcing the hearing and the opening statement of Senator Dole follows:]

## FISCAL YEAR 1984 BUDGET PROPOSALS

Senator Robert J. Dole (R., Kans.), Chairman of the Senate Committee on Finance, today announced hearings for June 15, 16, 22, 23, 28, and 29, 1983, on budget proposals for programs within the jurisdiction of the committee.

"The Williamsburg Summit Conference produced a clear message that Congress must act to reduce the projected Federal budget deficits to avoid jeopardizing the global economic recovery." Senator Dole stated, "In my view, the only 1984 budget blueprint that is likely to result in actual reduction of the deficit will be one that places the primary emphasis on spending reductions rather than on tax increases."

"Any new revenue—if needed—should come from tax reform not tax increases. The hearings I am announcing today should assist the Finance Committee in preparing to implement any balanced and responsible budget compromise that may emerge," Senator Dole concluded.

The hearings will begin on each day noted at 10:00 a.m. in Room SD-215 of the Dirksen Senate Office Building.

The following is a schedule of hearings:

### TAX EXPENDITURES

The hearings on June 28th and 29th will review the list of Federal tax expenditures. In announcing the hearings, Senator Dole noted, "While there may be a consensus that certain tax expenditures are justified such as the home mortgage deduction, for example, we have an obligation to review special tax breaks enjoyed by certain individuals or businesses to decide whether they are still functioning as intended and whether a particular incentive is justified in today's economy or could more carefully designed to accomplish the desired public policy goal more efficiently."

## PREPARED STATEMENT OF SENATOR DOLE

### TAX EXPENDITURES IN HISTORICAL PERSPECTIVE

Seventy years ago, the Sixteenth Amendment to the Constitution was adopted authorizing the taxation of income "from whatever source derived". In the same year, Congress imposed a graduated individual income tax, with tax rates ranging from one percent, to seven percent. That top rate of seven percent was reserved for those taxpayers whose income exceeded $500,000.

Last year, the maximum Federal income tax rate of 50 percent was imposed, for married couples, on income earned in excess of $85,600. But, as everyone in this room today knows, the Federal income tax was not imposed equally on all incomes "from whatever source derived", as the Constitution permits. Rather, it was imposed quite differently on different individuals, and corporations, with similar economic incomes.

The principal reason for the vast discrepancies in tax treatment experienced today under our Federal income tax system are the $295 billion of annual tax expenditures authorized by the Internal Revenue Code. Those tax expenditures, departures from a relatively strict definition of taxable income as economic income, are the subject of the hearings scheduled for today and tomorrow before the Senate Finance Committee.

### TAX EXPENDITURES IN ECONOMIC PERSPECTIVE

I know that numbers like $295 billion are difficult to comprehend. So, I would like to try to put the tax expenditure figures in perspective. For corporations, the figures are quite dramatic. In 1983, the corporate income tax provisions are estimated to raise less than $35.3 billion, while the corporate tax expenditures authorized by the code are more than $56 billion for the same year. In other words, we are foregoing more corporate taxes through the tax code than corporations are paying in taxes under the tax code.

### PURPOSE OF HEARINGS

Let me state that it is not my view that all tax preferences should be eliminated, or that, as a matter of principle, the tax code should be used only to tax economic income, strictly defined. My point is that we are in no imminent danger of achieving either of these goals. To the contrary, the abundance of tax expenditures have contributed to the complexity of the tax system, the perceived unfairness of the tax system, and the necessity for keeping tax rates higher than they would be if we did not provide exceptions, exclusions, and preferences almost as much as we impose taxes.

Because of the impact of tax expenditures on our tax system, I believe it is our responsibility to examine them with an eye towards curtailing or eliminating those tax subsidies that are unwarranted, or too ineffective or inefficient to be justified.

I look forward to hearing the testimony of our distinguished witnesses on the general subject of tax expenditures, and on any specific provisions they may wish to address.

The CHAIRMAN. We are about to begin our hearing this morning on tax expenditures.

In view of the vote on the budget resolution, I assume this committee will have extensive responsibility for trying to come up with some package, and I just thought that we ought to look at tax expenditures as we look at every other expenditure.

Seventy years ago the 16th amendment to the Constitution was adopted authorizing the taxation of income from "whatever source derived." In the same year, Congress imposed a graduated individual income tax, with tax rates ranging from 1 percent to 7 percent. That top rate of 7 percent was reserved for those taxpayers whose income exceeded $500,000.

Last year, the maximum Federal income tax rate of 50 percent was imposed for married couples on income earned in excess of $85,600. But as everyone in this room today knows, the Federal income tax was not imposed equally on all incomes "from whatever source derived," as the Constitution permits; rather, it was imposed quite differently on different individuals and corporations with similar economic incomes.

The vast discrepancies in the tax treatment experienced today under our Federal income tax system are primarily the result of the $295 billion of annual tax expenditures authorized by the code. Those tax expenditures, departures from a relatively strict definition of taxable income as economic income, are the subject of the hearings scheduled for today and tomorrow before the Senate Finance Committee.

I know that numbers like $295 billion are difficult to comprehend, so I would like to try to put the tax expenditure figures in perspective. For corporations, the figures are quite dramatic. In 1983, the corporate income tax provisions are estimated to raise less than $35.3 billion, while the corporate tax expenditures authorized by the code are more than $56 billion for the same year. In other words, we are foregoing more corporate taxes through the Tax Code than the corporations are paying in taxes under the code.

Let me state that it is not my view that all tax preferences should be eliminated, or that as a matter of principle the tax system should be used only to tax economic income, strictly defined. My point is that there is no imminent danger of achieving either of these goals. To the contrary, the abundance of tax expenditures has contributed to the complexity of the tax system, the perceived unfairness of the tax system, and the necessity for keeping tax rates higher than they would be if we did not provide exceptions, exclusions, and preferences almost as much as we impose taxes.

Because of the impact of tax expenditures on our tax system, I believe it is our responsibility to examine them with an eye towards curtailing or eliminating those tax subsidies that are unwarranted, or too ineffective or inefficient to be justified.

And I would also add that I would rather we take a look at these matters in our committee before the Budget Committee decides to extend their jurisdiction further than they have.

I would also like to include in the record at this point a letter I received yesterday from five of my Republican colleagues on this committee, Senator Roth, Senator Symms, Senator Armstrong, Senator Wallop, and Senator Grassley, indicating that they will not vote to raise any taxes for fiscal year 1984, despite the passage of the budget resolution. They point out that we have done a substantial amount of revenue-raising in this committee, and I would like their statement to be made a part of the record.

I include their letter to indicate that it is not easy, even though the budget resolution may have passed, to put together any package that might approach the $73 billion that we are reconciled to come up with over the next 3 years.

So it is my hope that these hearings and the hearings we have had in the past will help us address that problem.

[The letter follows:]

U.S. Senate,
*Washington, D.C., June 24, 1983.*

Hon. Robert Dole,
*Chairman, Senate Finance Committee,*
*Washington, D.C.*

Dear Bob: As you consider the agenda for the Finance Committee in the coming weeks, we want to inform you that we intend to oppose efforts to raise any taxes in fiscal year 1984, despite the passage of the Budget Resolution.

We believe that the Budget Resolution that passed the Senate is economic insanity, and we greatly regret that the Senate did not defeat the resolution. The country needs recovery far more than a budget resolution that raises $73 billion in taxes at just the time that economic stimulation and growth are needed.

In order to deal with deficits, this resolution should have focused on spending cuts, not tax increases. Instead, this measure is $15-22 billion over the President's request for total spending for fiscal year 1984. This resolution will insure that fully 24 percent of the nation's output will be consumed by the federal government's on-budget outlays alone. That's 24 percent that is denied to the private sector which would otherwise use it for job creation and economic growth. Including off-budget items and state and local government, at least 40 percent of the GNP will be extracted from the private sector. There is only one word for this situation: Intolerable!

We believe that the revenue targets ordered in the measure should be ignored and hope that you agree with us. It is literally impossible to find tax increases of the magnitude suggested in the resolution without doing serious violence to the economic recovery now taking place. Those who have come up with these tax numbers are deluding themselves if they think their figures can be met without creating major equity and growth problems in future years.

In the last ten months, the Finance Committee passed a $267 billion tax increase in TEFRA, a $22 billion gas tax increase and a $56.3 billion Social Security tax increase. Enough is enough. We flatly refuse to vote for another major tax increase at this stage in the economic recovery.

Therefore, we urge you to use your position to prevent the Finance Committee from becoming a part of this economic charade.

Sincerely,

William V. Roth, Jr.,
William L. Armstrong,
Steven D. Symms,
Malcolm Wallop,
Charles E. Grassley.

The Chairman. Senator Long, do you have anything?

Senator Long. No comments at this time, Mr. Chairman.

The Chairman. Pat.

Senator Moynihan. Yes, Mr. Chairman, I would just like to take note of all of the things you said and to put it in a certain context. The Lord works his way in—no, I should ask Senator Danforth. How is it the Lord works his way? In a wondrous manner?

Senator Danforth. You tell me. [Laughter.]

Senator Moynihan. I think he's forgotten already.

But just 2 years ago we adopted the 1981 legislation, the Economic Recovery Tax Act, which had foregone about $750 billion in revenues over a 5-year period. The New York Times had a financial section article by Professor Nordhaus of Yale, who had been a member of the Council of Economic Advisers under President Carter, on the 1981 act. It was a long lament for the demise of tax reform, commenting that there was no tax reform in ERTA and that this great and honorable tax movement had now succumbed to the forces of greed and aggrandizement.

I had the opportunity to write a response to Professor Nordhaus' article, in which I said simply, "Tax reform lives!" I said: The simple fact is the Treasury is now empty, and the administration is committed not to raise taxes. There will be no choice but to find reforms and loopholes and to discover, Mr. Chairman, that corporations receive more in the form of tax expenditures than they pay in taxes. This is something that would make corporations tremble if they heard it from the Democratic side of the aisle, but now they have to hear it from the other side.

I think it is in fact a duress which ought never to have come about. The $200 billion deficits as far as the eye can see, are a direct result of that tax cut which we all voted for.

We may in fact have a serious opportunity to remove inequities from the Tax Code, which are there and which have been consuming tax dollars for so many years. And I hope, Mr. Chairman, because we must do something, that we do the one thing that has been long looked to as needed and equitable and in the large interest of the tax system. That is, we must make the tax system a just an equitable one.

Thank you.

The CHAIRMAN. Thank you.

Senator Danforth.

Senator DANFORTH. We are happy to have as our first witness of the morning, Senator Howard Metzenbaum from Ohio.

Senator Metzenbaum, we are pleased to have you here. Your entire statement will be made a part of the record, and you may proceed in any way you wish.

## STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO

Senator METZENBAUM. Thank you, Mr. Chairman.

Mr. Chairman, this is a hearing on what might properly be called fairness and equity, because I think the issue before you has to do with the fairness and equity of the tax policies of our Nation.

There isn't much doubt that additional revenue is needed. Congressional action over the last 2 years has cut taxes by $860 billion, increased defense spending by $285 billion, cut nondefense social programs by $387 billion through fiscal year 1988, and as a consequence will add a whopping $757 billion to the deficit from 1982 to 1988, and the total deficit in the next 5 years will be $1.1 trillion.

Now, what is so shocking to me, and made it so difficult for me to digest my breakfast this morning, was the fact that five Republican Senators have just vowed to fight tax increases. And they say that they are urging you to disregard the budget—all of $12 billion in the first year, $15 billion in the second, and $46 billion in the third. And they talk about it being "economic insanity."

Mr. Chairman, I believe their position is economically irresponsible, I think it is morally decrepit, and I think it involves political buffoonery, because the facts are that we have a responsibility. These are the very same people who just a couple of years ago were talking about the need for a balanced budget and they are now saying we no longer worship at the shrine of a balanced budget—a 100-percent reversal.

I would say to you and to them that I would like to go to their States and let them defend publicly some of the matters about which I am to discuss this morning, having to do with tax loopholes, about why corporations pay no taxes, about why some corporations get more advantages in the tax laws than do others, because, frankly, Mr. Chairman, I don't believe some of the tax loopholes are defensible.

There is a distinction between tax increases and tax loopholes, but I would suppose some would say it comes out the same way.

In a recent Washington Post article, you said that our current income tax base resembles swiss cheese.

I differ with that description, Mr. Chairman, on the grounds that it is unfair to the cheese. [Laughter.]

But I certainly agree with your observation in that article that it is "simply unfair to raise tax rates when so many special tax breaks undermine the tax base and encourage inefficient allocation of resources." I couldn't agree more.

I want to suggest to the committee today a number of areas in which we can raise very substantial revenues in a manner that is both fair and economically efficient. I don't believe that the tax laws should be punitive, nor do I believe that they ought to provide for special privilege.

The first of these, Mr. Chairman, is enactment of a minimum tax on the income of profitable corporations. Now, I can't even claim credit for that idea—it's not a new idea—nor can anybody claim it as being a partisan idea. In presenting his fiscal year 1983 budget, President Reagan suggested enactment of a corporate minimum tax. He was right and we ought to do it. The intent was to insure that 90,000 profitable companies now paying little or no Federal tax will pay at least some tax on their profits.

Going back 3 years ago to 1980, the only figures available, there were 343,850 profitable companies in this country paying no tax at all. And I can't urge upon you strongly enough that your staff and committee inquire into why there should be any Government policy that makes it possible for companies making profits not to pay any taxes.

As a matter of fact, 16 Republican Senators in December 1981 expressed serious reservations about the decline in corporate tax revenues, and in a letter to the President they wrote—and incidentally, I think some of them are on this particular letter that you received today—"We are gravely concerned that by 1985 as many as half of all corporations may be paying no corporate taxes at all." I hope that in June 1983 they are as gravely concerned.

In the first 6 months of this year the Treasury collected $4 billion from corporations, and they paid out $12.6 billion in refunds, or a net that was 46 percent less than last year.

If you talk to any tax attorney in this community or anywhere in the country, they will tell you that the corporate income tax has now become a big joke. If you can't figure out a way, with ACR's and investment tax credits and various other procedures that are available to you—research and development credits and energy credits—and can't find out a way to keep from paying taxes, you ought to get yourself a new tax lawyer.

This year receipts from corporate income taxes will be 20 percent lower than last year's level. In 1950, corporations paid 31 cents on every Federal tax dollar; in 1983 they will pay only 12 cents on the dollar that is derived from that source.

The rate of taxation has also fallen. Effective corporate tax rate fell from 50 percent in 1950 to 39 percent in 1980, and according to the CBO the effective rate will continue to drop, reaching a new record low of 26.2 in 1988, a drop from a high of 50 percent to 26.2 percent.

In industry after industry the pattern is clear. A Joint Tax Committee study reports that in 1981 the paper and wood products industry had U.S. income of almost $1.4 billion. Now, on that kind of money they ought to pay some fair amount of taxes. The industry received refunds or tax credits of $193 million and they made $1.4 billion.

And frankly, I don't blame them; I blame us. We make the laws, and if we don't have sufficient courage to enact laws to see to it that there is some fairness and equity in our tax laws, then it is our fault, not theirs.

The railroads had $1.7 billion in income, and they received refunds and credits totaling $129 million. How can anybody explain making $1.7 billion and getting a refund of $129 million and paying no taxes?

The top crude oil producers earned nearly $1 billion in income but paid only $31 million in taxes, a 3.1 percent effective rate.

The chemical industry earned $3.1 billion but paid only 5 percent of that amount in taxes. That's a lower rate than any wage earner pays in this country.

Last March, General Electric reported that it had earned $1.8 billion in 1982. What did it pay in taxes? Not a darned penny. It received a tax refund of $146 million. They have to be laughing all the way to the bank about the stupidity, about the indifference of those of us in Congress who make that possible.

And why are profitable companies receiving refunds from prior year taxes and tax credits and reduced future liabilities? Mr. Chairman, we all know the answer to that, because over the years the special interests have successfully lobbied for tax subsidy after tax subsidy, and today the tax code is this Nation's most massive entitlement program.

The high profile issues are food stamps and social security, and medicare, medicaid, and AFDC as the entitlement programs. But look at the tax subsidy program, because it provides billions and billions of dollars in subsidies to some of this Nation's most profitable corporations.

Since the current administration assumed office, Congress has made a thorough review of every direct-spending program. Truly, drastic cuts have been made.

The President talks about cutting spending. We have done that. We have cut a total of $389 billion that have been taken from social programs between 1982 and 1988 fiscal years; but we have not undertaken that same detailed and exacting review of tax subsidy programs. We have cut medicaid and medicare, but we haven't reviewed the appropriateness of hospital revenue bonds or research and development credits for pharmaceutical companies. We have cut employment and training programs, but we haven't thoroughly reviewed the effectiveness of the targeted jobs credit.

We have reduced housing aid for the poor and elderly, but we haven't paid the same attention to the interest deduction for vacation homes.

We have reduced our commitment to weatherization and to low-income energy assistance programs, but we haven't reviewed tax subsidies for oil and gas producers.

If we are truly serious about reducing deficits, we need to look at more than one budget. We have the direct Federal budget, the one that contains Federal revenues and direct expenditures; but there is another Federal budget—an indirect budget that includes public subsidies for a vast range of activities.

Some items in the second Federal budget are clearly in the public interest, and I do not challenge them. One of those is the mortgage interest deduction for homeowners, a provision that has enabled millions of Americans to purchase their own homes. And over the years it has created millions of jobs in the home construction industry.

Tax subsidies that encourage retirement savings are easily defensible as well, as clearly being in the public interest. If we enable individuals to be financially independent at retirement age, we reduce the future costs of Federal programs, and these programs increase the savings pool, providing badly needed capital.

Mr. Chairman, I find the remotest policy justification for a number of the other tax subsidies in the second Federal budget. One of the least defensible of all is the half-billion dollar a year tax subsidy for the timber industry. I note with interest that they will be speaking today, and well they should, because I believe that their position is an indefensible one. They may tell you that their business isn't as good as it used to be, but that doesn't justify their not paying any taxes on the profits that they do make.

Since 1943, the timber industry has had a tax entitlement that permits them to treat the sale of timber as a capital gain. This means that instead of paying a tax rate on their profits as high as 46 percent, they need pay only 28 percent. The timber industry is one of the least taxed sectors of our economy. According to a recent study of corporate tax rates, the paper, fiber, and wood industry paid a 4-percent—4-percent—effective tax rate on U.S. income in 1981. A similar study conducted by the Joint Tax Committee reported that the paper industry paid—What?—a negative 14.2-percent rate.

The industry, in other words, receives so many tax writeoffs that companies either received a refund on prior taxes paid or a credit to reduce future tax bills.

I am not alone in my belief that the timber industry is not paying its fair share. In testimony before the Senate Finance Committee, your committee, John Chapoton, the Assistant Secretary of the Treasury, characterized timber as one of the most tax-favored of the domestic industries. He pointed to the capital gains treatment of timber, observing that profits received by manufacturers and producers of every other product are taxed at ordinary rates, and he pointed out that the timber industry receives a 10-percent tax credit and rapid depreciation for reforestation expenses.

Mr. Chairman, you come from Kansas and I come from Ohio. The gentleman next to you comes from Missouri, and the gentleman on the other side from Lousiana. The farmers in each of those States, when they make a profit on the products they grow, pay their taxes at ordinary tax rates. But those who grow timber, which is planted in the same manner as other crops, are allowed to treat their profits as capital gains. It is deeply ironic, Mr. Chairman, that timber growers enjoy preferential tax treatment even when they cut on Federal lands, a subsidy for having taken no risk at all.

I do not believe there is any justification for continuing to subsidize the timber industry, and I suggest to the committee that the timber tax subsidy be made a prime candidate in looking for the $73 billion in tax revenues.

I do not mean to suggest that all of it can be found in that area, but it is far from our only candidate. Banks and other financial institutions today enjoy a tax subsidy that will cost the American taxpayers $4.2 billion through 1988. And as the chairman knows, I offered an amendment to eliminate that particular item on the floor of the Senate the other day. You urged upon me at that time that I not press that amendment, and that these hearings were to be held, and that the commitee intended to look into that as well as into other matters. I do hope that you will.

I have already testified before this committee about the fact that this Nation's largest banks paid only $53 million in taxes in 1981 on profits of $1.9 billion. That is a tax rate of 2.7 percent. Part of that has to do with the bad-debt deduction, which is an artificial bad-debt deduction that no other business has.

How can we defend a billion dollar annual subsidy for an industry that earns billions in profits and pays so little in taxes? And how can we do so at a time when the administration says we don't have the money to help unemployed Americans save their homes from foreclosure by those same subsidized banks? The bank bad-debt deduction cannot be justified. It should be repealed.

Insurance is another of the Nation's specially favored industries. As the result of numerous special tax provisions, some of which go back as far as 1921, the six largest insurance companies were by 1981 paying an effective tax rate of only 13 percent.

In 1982, Congress repealed modified coinsurance, a practice through which insurance companies were able to enter into insurance arrangements among themselves and, in the process, treat as nontaxable the income that would otherwise be subject to taxation. Together with several other changes, this action will bring in approximately $4 billion in revenues by the end of this year.

It is my understanding that the committee is currently considering whether or not to extend several of the modifications made in the 1982 bill. I hope that the committee will proceed in this area on the presumption that insurance should be treated like any other industry. Those who wish to depart from that principle should bear the burden of proving that insurance industry tax subsidies are, in fact, in the public interest.

In addition, Mr. Chairman, I wonder why it is that we are subsidizing the oil industry to the tune of $28 billion through 1988?

In recent years the major oil companies of this country have used their profits to buy real estate and department stores, to enter the office equipment and newspaper business, to gobble up coal, uranium, and solar energy companies. They have taken a beating on some of those investments, but it is the American taxpayer who is taking the real beating by subsidizing these highly profitable companies. And to those who believe that tax entitlements for the oil companies should continue I say, "The responsibility is yours to prove your point."

Finally, I do not want to let this opportunity pass, Mr. Chairman, without commenting on the latest holes made by the Congress in our swiss cheese of a tax code.

Earlier this month the Senate passed the President's enterprize zone proposal and did so without hardly a word of debate. Its costs? To be honest, nobody really knows, but according to one Joint Tax Committee estimate, enterprize zones could cost $17.2 billion over the next 5 years. The bill includes a number of new supply-side tax benefits.

A 50-percent increase in the regular investment credit for machinery and equipment; a new 10-percent tax credit for structures; a new 10-percent tax credit for wage payments; a new 50-percent tax credit for wages paid to economically disadvantaged individuals; and the elimination of tax on long-term capital gains.

The result of all these new subsidies? A company investing in an enterprise zone will receive more than a dollar in tax writeoffs for each dollar in profit.

I hope that all of this will work; but, very frankly, I think that the time has come to call a halt to the practice of throwing tax subsidies around without regard to their cumulative effect on the budget. The best thing I can say about the enterprise zone legislation is that rumors are around that it won't get through the conference committee, and, if so, the American people will say a loud thank you.

I think it's time to take another look at the entire list of special tax entitlements. The hidden Federal tax budget for fiscal year 1983 includes $295 billion in tax subsidies through 109 different tax entitlement programs. There is no argument—some are worthwhile; many are not. Each should be reviewed. Each should be judged as to the public purpose they serve. And those which are inefficient and indefensible should be modified or repealed.

I sympathize with the concerns expressed by the chairman and others about the difficulties of raising $73 billion in tax revenues mandated by the budget resolution. I believe, however, that these funds can be raised—and raised without imposing new taxes on working Americans.

The President has proposed new taxes as a means of reducing the budget deficit: a 5-percent surcharge on individual and corporate income taxes—that would be most unfair.

A $5 per barrel oil excise tax, or 12 cents a gallon to the average person. How unfair that would be.

The taxation of employer-provided health insurance above certain levels. That's not the right answer.

These proposals would raise about $150 billion through fiscal year 1988.

Mr. Chairman, I believe these proposals are unnecessary and irresponsible. The job of raising the $73 billion can and should be accomplished by doing to the hidden Federal tax budget what has already been done to direct spending.

Mr. Chairman, I stand ready to work with the chairman and the committee in any effort you might undertake to repeal billions of dollars in unproductive tax subsidies.

I thank you for tolerating the length of my statement, Mr. Chairman.

[The prepared statement of Senator Metzenbaum follows:]

## STATEMENT OF SENATOR HOWARD M. METZENBAUM

Mr. Chairman, in a recent op-ed piece in the Washington Post, you described our current income tax base as "resembling swiss cheese."

I differ with that description, Mr. Chairman, on the grounds that it is unfair to the cheese. But I certainly agree with your observation in that article that "it is simply unfair to raise tax rates when so many special tax breaks undermine the tax base and encourage inefficient allocation of resources."

I want to suggest to the Committee today a number of areas in which we can raise very substantial revenues in a manner that is both fair and economically efficient.

The first of these, Mr. Chairman, is enactment of a minimum tax on the income of profitable corporations.

This is by no means a new idea, nor can it by any stretch of the imagination be described as partisan.

In presenting his fiscal year 1983 budget, President Reagan suggested enactment of a corporate minimum tax. The intent was to ensure that 90,000 profitable companies now paying little or no Federal tax will in the future be liable at least for some tax on their profits.

In December, 1981, Mr. Chairman, sixteen Republican Senators expressed serious reservations about the decline in corporate tax revenues. In a letter to the President, they wrote "We are gravely concerned that by 1985, as many as half of all corporations may be paying no corporate taxes at all."

This year, receipts from corporate income taxes will be twenty percent below last year's level.

In 1950, corporations payed thirty one cents on every Federal tax dollar. In 1983, only twelve cents on the dollar is derived from that source.

And the rate of taxation has also fallen.

The effective corporate tax rate fell from 50 percent in 1950 to 39 percent in 1980. And according to the Congressional Budget Office, the effective rate will continue to drop, reaching a new record low of 26.2 percent in 1988.

In industry after industry, the pattern is clear.

A Joint Tax Committee study reports that in 1981, the paper and wood products industry had U.S. income of almost $1.4 billion. Yet, the industry received refunds or tax credits of $193 million.

—Railroads had $1.7 billion in income. They received refunds and credits totaling $129 million.

—The top crude oil producers earned nearly $1 billion in income, but paid only $31 million in taxes, a 3.1 percent effective tax rate.

—The chemical industry earned $3.1 billion dollars, but paid only 5 percent of that amount in taxes.

Last March, General Electric reported that it had earned $1.8 billion in 1982. Yet, it received a tax refund of $146 million.

Why are profitable companies receiving refunds from prior years taxes and tax credits to reduce future liabilities?

Mr. Chairman, we all know the answer to that. It is because over the years the special interests have successfully lobbied for tax subsidy after tax subsidy. And today the tax code is the nation's most massive entitlement program. It provides billions and billions of dollars in subsidies to some of this nation's most profitable corporations.

Since the current Administration assumed office, Congress has made a thorough review of every direct spending program. And truly drastic cuts have been made—a total $389 billion taken from social programs between the 1982 and 1988 fiscal years.

But we have not undertaken that same detailed and exacting review of tax subsidy programs.

We have cut Medicaid and Medicare, but we haven't reviewed the appropriateness of hospital revenue bonds or research and development credits for pharmaceutical companies.

We have cut employment and training programs, but we haven't thoroughly reviewed the effectiveness of the targeted jobs credit.

We have reduced housing aid for the poor and the elderly, but we haven't paid the same attention to the interest deduction for vacation homes.

We have reduced our commitment to weatherization and to low income energy assistance programs, but we haven't reviewed tax subsidies for oil and gas producers.

If we are truly serious about reducing deficits, we need to look at more than one budget.

We have the direct Federal budget—the one that contains Federal revenues and direct expenditures.

But there is another Federal budget—an indirect budget that includes public subsidies for a vast range of activities.

Some items in the second Federal budget are clearly in the public interest.

One of those is the mortgage interest deduction for homeowners, a provision that has enabled millions of Americans to purchase their own homes. And over the years, it has created millions of jobs in the home construction industry.

Tax subsidies that encourage retirement savings are easily defensible as clearly in the public interest. If we enable individuals to be financially independent at retirement age, we reduce the future costs of Federal programs. And these proposals increase the savings pool, providing badly-needed capital.

But, Mr. Chairman, I find the remotest public policy justification for a number of the other tax subsidies in the second Federal budget.

One of the least defensible of all is a half billion dollars a year tax entitlement for the timber industry.

Since 1943, the timber industry has had a tax entitlement that permits them to treat the sale of timber as a capital gain. This means that instead of paying a tax rate on their profits as high as 46 percent they need only pay 28 percent.

The timber industry is one of the least taxed sectors of our economy. According to a recent study of corporate tax rates, the paper, fiber, and wood industry paid a four percent effective tax rate on U.S. income in 1981. A similar study conducted by the Joint Tax Committee reported that the paper industry paid a negative 14.2 percent rate. The industry, in other words, received so many tax write-offs that companies either received a refund on prior taxes paid or a credit to reduce future tax bills.

I am not alone in my belief that the timber industry is not paying its fair share.

In testimony before the Senate Finance Committee, Assistant Secretary of the Treasury John Chapoton characterized timber as "one of the most tax favored of domestic industries." He pointed to the capital gains treatment of timber, observing that profits received by manufacturers and producers of every other product are taxed at ordinary rates. And he pointed out that the timber industry receives a 10 percent tax credit and rapid depreciation for reforestation expenses.

The farms of my state of Ohio, when they make a profit from growing corn, wheat, or soybeans, pay their taxes at ordinary tax rates. But those who grow timber, which is planted in the same manner as other crops, are allowed to treat their profits as capital gains.

It is deeply ironic, Mr. Chairman, that timber growers enjoy preferential tax treatment even when they cut on Federal lands—a subsidy for having taken no risk at all.

I do not believe that there is any justification for continuing to subsidize the timber industry. And I suggest to the Committee that the timber tax subsidy be made a prime candidate in looking for the $73 billion in tax revenues called for in the budget resolution.

But it is far from the only candidate.

Banks and other financial institutions today enjoy a tax subsidy that will cost the American taxpayers $4.2 billion through 1988.

I have already testified before this Committee about the fact that this nation's 20 largest banks paid only $53 million in taxes in 1981, on profits of $1.9 billion. That's a tax rate of 2.7 percent.

Part of the reason for this low effective tax rate is a tax subsidy known as the artificial bad debt deduction. Since 1951 the banks have enjoyed this special treatment. No other business has it.

If other businesses have bad debts, they write them off. But under this special entitlement, banks and other financial institutions are permitted to compute and deduct amounts far in excess of their actual losses.

How can we defend a billion dollar annual subsidy for an industry that earns billions in profits and pays so little in taxes?

And how can we do so at a time when the Administration says we don't have the money to help unemployed Americans save their homes from foreclosure by those same subsidized banks?

The bank bad debt deduction cannot be justified. It should be repealed.

Insurance is another of the nation's specially-favored industries. As the result of numerous special tax provisions, some of which go back as far as 1921, the six largest insurance companies were by 1981 paying an effective tax rate of only 13 percent.

In 1982, Congress repealed "modified coinsurance," a practice through which insurance companies were able to enter into insurance arrangements among themselves and in the process, treat as non-taxable income that would otherwise be subject to taxation. Together with several other changes, this action will bring in approximately $4 billion in revenues by the end of this year.

It is my understanding that the Committee is currently considering whether or not to extend several of the modifications made in the 1982 bill. I hope that the committee will proceed in this area on the presumption that insurance should be treated like any other industry. Those who wish to depart from that principle should bear the burden of proving that insurance industry tax subsidies are, in fact, in the public interest.

In addition, Mr. Chairman, I wonder why it is that we are subidizing the oil industry to the tune of $28 billion through 1988.

In recent years, the major oil companies of this country have used their profits to buy real estate and department stores, to enter the office equipment and newspaper businesses, and to gobble up coal, uranium and solar energy companies.

They've taken a beating on some of these investments. But it is the American taxpayer who has taken the real beating by subsidizing these highly profitable companies. And to those who believe that tax entitlements for the oil companies should continue, I say "prove your point."

Finally, I do not want to let this opportunity pass, Mr. Chairman, without commenting on the latest holes made by the Congress in our "swiss cheese" of a tax code.

Earlier this month the Senate passed the President's enterprise zone proposal and did so with hardly a word of debate.

It's cost?

To be honest, nobody really knows. But according to one Joint Tax Committee estimate, enterprise zones could cost $17.2 billion over the next five years.

The bill includes a number of new supply-side tax benefits:

A 50 percent increase in the regular investment credit for machinery and equipment;

A new 10 percent tax credit for structures.

A new 10 percent tax credit for increased wage payments;

A new 50 percent tax credit for wages paid to economically disadvantaged individuals; and,

The elimination of tax on long-term capital gains.

The result of all these new subsidies? A company investing in an enterprise zone will receive more than a dollar in tax write-offs for each dollar in profit.

I hope that all of this will work; but very frankly, I think that the time has come to call a halt to the practice of throwing tax subsidies around without regard to their cumulative effect on the budget.

I say that it's time to take another look at the entire list of special tax entitlements.

The hidden Federal tax budget for fiscal year 1983 included $295 billion in tax subsidies through 109 different tax entitlement programs.

Some are positive. Many are not.

Each should be reviewed. Each should be judged as to the public purpose they serve. And those which are inefficient, and indefensible should be modified or repealed.

I sympathize with the concerns expressed by the Chairman and others about the difficulties of raising $73 billion in tax revenues mandated by the Budget Resolution. I believe, however, that these funds can be raised—and raised without imposing new taxes on working Americans.

The President has proposed new taxes as a means of reducing the budget deficit.

—a 5 percent surcharge on individual and corporate income taxes.

—a $5 per barrel oil excise tax.

—the taxation of employer-provided health insurane above certain levels.

These proposals would raise about $150 billion through fiscal year 1988.

Mr. Chairman, I believe that these proposals are unnecessary and irresponsible.

That job can and should be accomplished by doing to the hidden Federal tax budget what has already been done to direct spending. And I stand ready to work with the Chairman and the Committee in any effort you might undertake to repeal billions of dollars in unproductive tax subsidies.

The CHAIRMAN. Thank you very much, Senator Metzenbaum.

Somebody handed me last Friday's June 24 Wall Street Journal, where it indicates the budget deficit hit a high in May of almost

$30 billion. In that story it indicates that tax refunds to corporations exceeded collections by $302 million in May, marking the fourth negative corporate tax collection month since the start of the fiscal year, and the corporate tax collections for the first 8 months of the year totaled $16.7 billion compared with $31.4 billion a year earlier.

Of course a lot of that is due to the recession. Many corporations I know of have not made any profit, so I assume that's a primary factor for the loss; but even if you looked at the Carter budget assumptions, the corporate collections would be around $70 billion, and we are now suggesting they may be about $26 billion. So they are much due to the recession, but they still, as you indicated, are a rather sharp reduction.

Senator Long, do you have questions?

Senator LONG. No questions, Mr. Chairman.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Senator Metzenbaum, you have pointed out a number of areas where you think the tax incentives or tax benefits are unjustified. You have also stated that there are some areas where they are justified, and you have suggested, for example, the mortgage interest deduction.

I wonder if you could at some point furnish us with a list of those tax expenditures which you believe should be repealed and an estimate as to how much we would collect in additional revenue if we were to repeal them.

Senator METZENBAUM. I would be very happy to do so, and I might say that I'm not alone in that approach. Mr. David Stockman, with whom I have oftentimes disagreed, in his testimony before the Budget Committee made it clear about a year or two ago that he had actually discussed the matter of some of these tax loopholes at the White House and had not been successful.

When I asked him to go through a list with me, he responded that just about each of them that I was talking about had been raised in that discussion. And in his Atlantic Monthly article he confirms the fact that he did indeed discuss those.

I would be very pleased. We do have the list available, and I will make the list available to you very promptly. I thank you for your input.

[The list from Senator Metzenbaum follows:]

|  | ($ Billions) |  |  |  |
|---|---|---|---|---|
|  | FY 84 | FY 85 | FY 86 | Total |
| President's FY 83 Corporate Minimum Tax Proposal | 4.8 | 4.5 | 3.7 | 13.0 |
| Artificial Bad Debt Reserve for Financial Institutions | 0.4 | 0.8 | 0.9 | 2.1 |
| Eliminate Capital Gains Treatment of Timber Income | 0.2 | 0.6 | 0.7 | 1.5 |
| Freeze the Estate Tax Unified Credit and Maximum Tax Rates | --- | 0.7 | 1.6 | 2.3 |
| Repeal Expensing of Intangible Drilling Costs | 2.6 | 4.5 | 4.2 | 11.3 |
| Require Cost Depletion Instead of Percentage Depletion for Oil and Gas | 0.9 | 1.7 | 1.9 | 4.5 |
| Lengthen the Recovery Period for Real Property to 25 Years and Require Straight-line Depreciation | 0.6 | 2.3 | 4.6 | 7.5 |
| Require Full Basis Adjustment | 0.3 | 1.3 | 2.6 | 4.2 |
| Governmental Lease Financing Reform Act | 1.0 | 1.0 | 1.0 | 3.0 |
| Delay Indexing | --- | 6.2 | 16.6 | 22.8 |
| Eliminate Tax-Exempt Hospital Bonds for For-Profit Hospitals | 0.1 | 0.3 | 0.6 | 1.0 |
| Curb Income Averaging | 1.7 | 1.9 | 2.1 | 5.7 |
| Total | 12.6 | 25.9 | 40.6 | 79.1 |

The **Chairman**. I would just say there are some who say you shouldn't try to make a laundry list now, "you ought to go for the big-ticket items," that there ought to be some big-ticket items out there, if in fact we can raise the $73 billion.

My view is, before you start raising anyone's taxes we ought to make certain that we've at least addressed some of the glaring areas that should be addressed. That is not easy, but——

Senator **Metzenbaum**. Mr. Chairman, I might say to you that I think the one that really could fly and could be justified and I think would be hard to oppose is the minimum corporate tax, because it was in the first instance a suggestion of the President, and it's pretty hard to defend corporations making substantial profits and paying no taxes. It is much more difficult to say that somebody's taxes should be raised than it is to say that somebody who is paying no taxes ought to at least pay some tax, at whatever that rate might be. And that would be a substantial factor if you enacted a minimum corporate tax.

Senator **Long**. I would like to just ask about one subject, Senator. You referred to various companies as paying no taxes. I know you mentioned oil companies as among those.

Senator **Metzenbaum**. No, as a matter of fact, they are not in that category as much. I think they are paying an effective rate of about——

Go ahead. I don't mean to interrupt you.

Senator **Long**. Well, you list them among those who pay very little tax.

Senator **Metzenbaum**. That's right.

Senator **Long**. Can you tell me, how much are those companies paying in windfall profits taxes this year?

Senator **Metzenbaum**. I cannot give you the specific number, but I will be very happy to make it available to you. But I would say to you that the figures I provided you with, I'm quite certain included the effects of the windfall profits tax as well as the regular corporate income taxes.

Senator **Long**. My impression is that on the average the oil industry paid about 5 percent of gross in taxes—State, Federal, whatever.

Now, the oil industry in Louisiana, where I'm familiar with it, pays about 12 percent severance tax on oil when it takes it out of the ground. Then, in addition to that, it pays a windfall profits tax varying from 30 percent to 70 percent, and that tax of course applies on the price above roughly $14. So the industry is paying, on about half of that, it is paying a tax anywhere from 30 to 70 percent.

Now, just to try to reach an average, I would say it must be paying about 25 percent. I think it is safe to say it is paying about 25 percent of its gross income in windfall profits tax, and with the 12-percent severance tax that would be about 37 percent, compared to an average of about 5 percent on net income.

Neither one of those two taxes do we call an income tax, but it's a tax on their gross income rather than a tax on their net. That works out to be a great deal more than industry on the average pays.

Now, that's not a tax they can pass on in the price of their product. Anybody is going to pass the tax on, if he can, but that one they can't; the price they charge is governed by the world market price, and that's what they have to compete with.

Are you aware of the fact that half our rigs are shut down right now?

Senator **METZENBAUM**. I am aware of the fact that there is a substantial decline in demand for oil by reason of the economic conditions that exist in the country. That I'm aware of. But I think that condition will change.

And I think, Senator Long, what I'm saying is, I'm not denying whether they pay severance taxes in Louisiana and perhaps other kinds of taxes in other States, but the thrust of my concern is that the tax laws of this Nation be fair and equitable. And all companies pay various kinds of taxes. The utility companies in this community pay a special kind of tax, and in other States you have other kinds of intangible taxes.

The bottom line is, what is left after that? And how much of that do you pay to the Federal Government in order to make this Government of ours run?

Somebody has to pay part of that burden. And when you don't, you have a deficit of the kind we are talking about, $1 trillion over the next 5 years.

With that, the money that they have will be worth so much less because inflation is bound to return and interest rates to go up.

All I am really saying is that this committee has a tough job, but if you bite the bullet, and once you start to move in and eliminate some of the tax preferences that exist—and I'm not saying some don't have some justification—then I think you will take a long step forward in bringing about a better economic condition in this country and also a feeling among more people in this country that our tax laws are fair and equitable.

Senator **LONG**. Well, Senator, you are on the Energy Committee, are you not?

Senator **METZENBAUM**. I surely am.

Senator **LONG**. If you are not familiar with this fact, I urge you to familiarize yourself with it: the price of oil has gone down; it has gone down while Mr. Reagan has been President. I think that is one of the principal reasons why inflation has gone down. They might say something else, but that's the principal reason inflation has not gone up as much as it was going up prior to that time. The big declining factor has been the drop in oil prices.

In fact, I have had economists tell me that 70 percent of the inflation that occurred under Mr. Carter, and 70 percent of the declining inflation that has occurred under President Reagan, is due to the decline in energy prices; oil and gas, but mainly oil.

When the oil price went down—I can speak for Louisiana because we produce more per acre than any State in the Union—that decline in the price gave all the oil companies, big and little alike, a genuine cash flow problem.

To try to meet that problem, they did what any good business ought to try to do, they got their costs down. That industry is not unionized as much as most industries are—much less, in fact—and that made it easier for them to do something that other companies would have had greater difficulty in doing: they laid off a tremendous number of people, which means that Louisiana is one of the higher unemployment States, because of that.

Those whom they kept they called in and said, "Now look, we want to keep you on here, but you are going to have to take about a 30-percent pay cut." So out of those that they kept, which were their best, those employees had to take a big pay cut.

Of course, doing all of that, and doing what they could to cut their transportation and materials costs, that enabled them to reduce their costs, which helps to keep the industry going to the extent that it is.

We've only got about half of our rigs operating, and the country needs all that energy. We need all that oil. It helps with our balance of payments.

But I would submit to you that that industry right now is having a difficult time of it, and you are going to run into that more and more as you go into this natural gas bill. They are having a tough time making it. With this additional tax you are talking about, I don't think it could help. I don't care what you call it, it is a tax.

Senator **Metzenbaum**. I don't want any additional tax; I just don't want them to have an unfair preference that other taxpayers of the country do not enjoy. And if they do, then I think this committee should eliminate it.

Senator **Long**. But, Senator, since when does a tax fail to be a tax because it's not an income tax? Or because you call it by a different name?

Senator **Metzenbaum**. Well, I don't believe it is a tax if you're not paying it. It's no tax if you aren't paying it. It's only a tax when you pay it.

Senator **Long**. But if I am paying the Government let's say 37 percent of my gross income, if I'm paying that without knowing whether I will have a profit or not, if I am paying 37 percent and the average tax paid in manufacturing is 5 percent, can you fairly call me a "favored taxpayer"?

Senator **Metzenbaum**. Well, I think it becomes a question of whether you are paying 37 percent in Federal income taxes or whether you are talking about 37 percent in all of your taxes, including the severance taxes and the State taxes. You've got to compare apples with apples.

I would say to you that if you can prove to your fellow Senators on this committee that the oil industry pays a 37-percent tax and the rest of corporate America pays 26.9, my guess is they will have difficulty in changing the law. I think you may have some difficulty in proving that point.

Senator **Long**. Well, let me just tell you, Senator, if I'm not right about this, why, I would be pleased for you to show me I'm wrong.

One of the reasons that the industry pays less in income tax is because it pays so much more in other taxes.

Senator **Metzenbaum**. But also it is a fact that it has the depletion allowance, it has the foreign tax credit, it has the ACRS advantages, and the intangible writeoffs that other corporations don't have. So it does have a number of preferential treatments that have been put in the law.

All I am saying is: Make the tax laws fair and equitable. That's the only premise on which I stand, and I think you would have to agree, Senator, that that's a pretty hard position to challenge. All I'm saying is make them fair and equitable.

Senator **Long**. Well, please understand what I'm saying: First, this is a depressed industry today. Second, it is an industry that we need very much because we need the energy. We need it for our security. We need it for our own people as well as for a serious emergency. Third, the industry pays a huge amount of taxes that other industries are not paying.

Senator **Metzenbaum**. It pays no tax on its losses. If it's depressed and not making money, there are no income taxes on that.

Senator **Long**. When you pay a huge tax on your gross income, and then people give you no credit for it, it seems to me that at a minimum you have a right to ask that you take a look at that.

Senator **Metzenbaum**. I don't think the question is a tax on gross. I used to be in a business where I paid as high as 99 percent of my gross receipts as my rent and still wound up making a profit. To me the only question was could I make a profit. And I think the only question here is what's fair and equitable, and not whether it is a high percentage of the gross.

I'm afraid that the chairman is looking at me and saying, "I'd like to get rid of you, sir."

The **Chairman**. No; I'm just looking at the witness list here.

Senator **Metzenbaum**. Whatever you say, sir.

Senator **Long**. Well, let's just assume, Senator, that out of $100 of income you take $50 of it in taxes. Then you proceed to say that on the $50 that's left I'm only paying a tax of 2 percent; but in both cases you were taxing income. In one case you are taxing gross and in the other case you are taxing net. What have you got left after taxes?

When you think in terms of how much someone is paying it just seems to me you ought to look at the entire amount he is paying on his income rather than at the final tax you hit him with.

Thank you, Senator Metzenbaum.

Senator **Metzenbaum**. Thank you very much for your patience.

The **Chairman**. Thank you very much, Senator Metzenbaum.

For our next witness we are pleased to have Dr. Rivlin, Director of the CBO—Congressional Budget Office.

Dr. Rivlin, you have been a frequent visitor to our committee. We have always appreciated your testimony, and we would be pleased to hear you now. We didn't give you much notice either. We appreciate that. Your entire statement will be part of the record. Thank you.

## STATEMENT OF DR. ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, D.C.

Dr. **Rivlin**. Thank you very much, Mr. Chairman.

I am very pleased to be here. You have a hard problem and I think a very important one. The threat of Federal deficits over the next several years is an exceedingly serious one. If spending and taxing policies are not changed in accordance with the budget resolution or some other way, deficits will mount in the future even as the economy improves.

Nobody likes to raise taxes, but nobody likes deficits either, and at the moment the deficits seem a worse threat to the continuation *of the recovery now underway than the pain caused by some revenue* increase and some spending cut. The resolution calls for both, and I think it is clear that not all of the deficit gap can be closed on either side; it is going to take some spending cut, which will be painful, and some revenue increase, which will also be painful.

But as has been stated earlier, in part this difficult situation creates an opportunity. It creates an opportunity to improve the tax system, to make it more fair, and to structure it so that it exerts less drag on the economy.

I know that you are considering some major proposals for restructuring the tax system, perhaps moving more toward consumer taxation; but those major proposals will take time, and the problem of the moment is to close the deficit gap and to raise some revenue in the near term.

So the options before you would seem to be, in addition to some restructuring for the future, how to raise revenues in a less drastic way.

One set of possibilities includes shifting to consumer taxation as in excise taxes or increased energy taxes, some of which, despite the difficulties for the energy industry, might have other benefits, such as increasing the incentive to conserve.

Or, alternatively, one could broaden the base of the income tax itself, moving along the line that this committee did last year in TEFRA but going toward further base broadening, which might have the benefits of making the system fairer in the process.

We have suggested a few of those points in this testimony, and let me pick up on page 8 with some of the specifics:

## POSSIBLE BASE-BROADENING OPTIONS

The Congress could also raise additional revenues by eliminating or reducing several tax expenditure provisions. This base-broadening approach was used last summer in TEFRA. Broadening the tax base in this way can make the economy more efficient, by reducing the Federal Government's role in determining the allocation of resources and increasing the influence of the free market. It can also make the tax system more fair by treating incomes from different sources more alike. Below is a list of possible options for base broadening; a much more extensive list can be found in CBO's February 1983 report on reducing the deficit.

One possibility is repeal of the percentage depletion allowance for oil and gas. Independent oil and gas producers are allowed to use percentage depletion instead of cost depletion to recover the costs of discovery and development of oil and gas wells. Eliminating percentage depletion would increase Federal revenues by $0.9 billion in fiscal year 1984 and by about $4.5 billion for the fiscal years 1984 through 1986. [These are all detailed in table 2 of Dr. Rivlin's prepared statement.] The provision was intended to encourage domestic energy production by relatively small-scale producers, but the sharp rise in oil and gas prices in recent years may provide sufficient incentive to potential producers.

Another possibility is repealing the expensing of intangible drilling costs for oil and gas. Taxpayers engaged in oil and gas drilling may deduct the amount they spend on intangible drilling costs in the year the expenditure is made, instead of amortizing the amount over the life of the well. While TEFRA cut back this provision somewhat, repealing expensing entirely would increase Federal revenues by $2.6 billion in fiscal year 1984 and by about $11 billion in fiscal years 1984 through 1986. Proponents of tax incentives available to the industry provide sufficient encouragement; opponents want to retain the provision in order to help promote a more independent national energy supply.

Another possibility is to limit the consumer and mortgage interest deductions to $10,000 per taxpayer. Limiting all consumer and mortgage interest deductions to $10,000, paralleling the limit on investment interest deductions, would affect 1 percent of all taxpayers and would raise about $0.6 billion in fiscal year 1984 and about $4 billion in fiscal years 1984 through 1986. The proposal would limit deductions of all interest payments on home mortgages, auto loans, installment purchases, credit card carryovers, and other consumption borrowing.

One could lengthen the building depreciation period to 20 years. Since the enactment of ERTA, both new and newly purchased buildings can be depreciated over 15 years, using the 175 percent declining balance method. Lengthening the tax life for structures from 15 to 20 years would raise $0.4 billion in fiscal year 1984 and about $6 billion in fiscal years 1984 through 1986. While a longer period might introduce some distortion of investment allocation, it would more closely approximate the structure's useful life.

Repealing the net interest exclusion. A tax exclusion of up to $450 of net interest income will be available to individuals starting in 1985; up to $900 for joint returns. Repeal of the exclusion would raise about $4 billion in fiscal years 1985 and 1986. The provision was enacted to reduce taxes on savings, but savings could also be encouraged—at a further revenue gain—by restricting existing tax incentives for consumer borrowing.

One could require full basis adjustment for the investment tax credit. To reduce the overlap of benefits from accelerated depreciation and the investment tax credit, in TEFRA, the Congress limited the depreciable basis of an asset to its price minus 50 percent of the eligible investment credit. A full basis adjustment would restrict depreciation to a firm's net cost of the asset—90 percent in the case of the regular investment credit. If applied to investments in machinery and equipment, this proposal would increase Federal revenues by $0.3 billion in fiscal year 1984 and by about $4 billion over the 1984–86 period.

One could tax nonstatutory fringe benefits. If the Congress permitted the Internal Revenue Service to issue regulations governing the taxation of most fringe benefits, including, for example, private use of a company car, reduced price meals, and discounts on employers' products, the revenue gain would be about $0.6 billion in fiscal 1984 and $3 billion over the 1984–86 period. The present exemption encourages employees to bargain for nonwage forms of compensation. This shrinks the tax base and misallocates resources. Taxing certain fringe benefits, however, could be complicated and costly.

Along the same lines, one could tax some employer-paid health insurance. Employees do not pay income tax or payroll tax on income received in the form of employer-paid health coverage. One proposal to limit the present exclusion treats amounts exceeding $160 a month for families and $65 a month for individuals as taxable income. This would increase income tax revenues by $2.7 billion in 1984 and by about $14 billion in the fiscal years 1984 through 1986. It would increase payroll tax revenues, also, by $0.8 billion in fiscal 1984 and by about $4 billion in fiscal years 1984 through 1986. Many observers feel that the exclusion encourages overuse of health care services, thereby driving up health care costs.

The final example would be the elimination of the deductibility of State and local sales taxes. Eliminating the itemized deduction for State and local sales taxes would increase Federal revenues by $0.9 billion in fiscal year 1984 and by about $13 billion in fiscal years 1984 through 1986. While sales taxes reduce taxpayers' net income, they are the kind of small, uniform, and predictable expense that is implicitly taken into account when the zero-bracket amount, personal exemptions, and general tax rates are established.

In conclusion, Mr. Chairman, there are a lot of possibilities—none of them without objections, but we offer a few in the hope of finding a solution of this very difficult problem.

[The prepared statement of Dr. Alice M. Rivlin and her answers to Senator Dole's questions follow:]

## STATEMENT BY ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I am pleased to have this opportunity to appear before the Committee as you consider the extremely important task of reducing the budget deficits now looming ahead. The First Concurrent Budget Resolution for Fiscal Year 1984 (H. Con. Res. 91), passed on June 23, calls for substantial tax increases and expenditure cuts during the next three years. In particular, the resolution specifies revenue increases of $12 billion in fiscal year 1984, $15 billion in 1985, and $46 billion in 1986. In the absence of revenue increases, deficits are projected to remain in the $180 billion to $200 billion range.

There are many ways of raising revenues in response to deficit-reduction needs of this dimension: across-the-board tax rate increases, increases in excise taxes, a continuation of the base-broadening approach exemplified by last year's Tax Equity and Fiscal Responsibility Tax Act (TEFRA), or a combination of these approaches.

I will first mention major changes for raising revenues that could provide a significant portion of the tax increases sought and then I will discuss excise tax increases and tax changes that would broaden the individual and corporation income tax bases, resulting in increases that could be combined to raise the revenues sought.

### ACROSS-THE-BOARD TAX RATE INCREASES

Discussion is proceeding in this Committee and elsewhere about a basic restructuring of the tax system. Particular changes under discussion include a substantial broadening of the individual income tax base combined with a general lowering and reduction in the range of rates applied to this base; integration of the corporate and individual income taxes; and a partial or complete replacement of our present income tax system with a consumption tax or value-added tax. However, fundamental restructuring takes time. The question at hand is how best to respond to the consensus expressed in the budget resolution that revenues should be raised substantially over the next three years.

### CAPPING THE INCOME TAX REDUCTIONS

Since the third round of the individual income tax rate reductions is scheduled to be carried out by changes in withholding rates beginning this Friday, the scope of possible revenue increases from altering these changes is greatly reduced. For example, a cap on this rate reduction of $720 dollars per return would raise between $6 billion and $8 billion per year over the 1984–1986 period.

### CONTINGENCY TAXES

As part of its budget plan for fiscal year 1983, the Administration has proposed a 5 percent individual income tax surcharge and a $5 per barrel oil excise tax, to go into effect in 1986 for three years if, by 1985, certain specified conditions are met. CBO estimates that these temporary taxes would raise almost $40 billion in 1986, about half from the income tax surcharges and half from the oil excise tax. Part or all of these increases could be moved forward to reduce deficits sooner.

### DELAY OF INDEXING

An automatic rise (indexation) in the zero bracket amount, personal exemption, and tax rate brackets, provided in the Economic Recovery Tax Act of 1981 (ERTA), is scheduled to go into effect in calendar year 1985. The rescinding of indexing or its delay beyond 1986 would increase revenues by about $6 billion in 1985 and $17 billion in 1986.

Indexing has considerable appeall as a device to prevent the unlegislated increases in real individual income tax liabilities that result solely from the effects of inflation on the tax system (commonly called "bracket creep"). If the federal government is consdered likely to be short of tax revenues in 1985 and thereafter, however, the revenue gain from repealing indexing might seem desirable both in its timing and its sensitivity to economic conditions.

A possible drawback to the repeal or postponement of indexing is that it would have different effects on taxpayers at the low and high ends of the income spectrum. Compared with indexation of the exemptions and the tax rate brackets, the three-year tax rate cuts under ERTA were more generous to upper-income taxpayers and less generous to those with lower incomes. If indexing was repealed, one might argue that taxpayers with lower incomes would continue to be less than fully compensated for the bracket creep caused by inflation since the late 1970s.

Indexing can also be justified as a way of continuing the pressure for discipline in federal spending and tax policy. It assures that real individual income tax revenues increase at roughly the rate of growth in real incomes, thus requiring that spending increases be similarly limited if future deficits are not to increase. It also limits the opportunities for increases in tax expenditures and other special-purpose tax provisions, and imposes pressure to reduce those that now exist.

### EXCISE TAX INCREASES

Federal revenues could also be increased through selective changes in excise taxes, or through the enactment of new excises. New or increased excise taxes would put the burden of narrowing the deficit on consumption, rather than work or saving; this would tend to reinforce our long-term push toward more rapid growth of output and productivity. On the other hand, increased exise tax collections cannot be so finely targeted on taxpayer groups according to their ability to pay, and so the perceived fairness of the tax system might suffer.

New or increased excise taxes on energy are high on some lists of suggested revenue raisers. Increasing the price of energy to consumers would encourage conservation. Improvements in the energy efficiency of our capital stock, and continued investments in home insulation and more fuel-efficient appliances and autos would pay dividends for years to come, as well as reduce our nation's long-run vulnerability to a sudden interruption of fuel imports. The current lower-than-expected energy prices may provide an environment in which increases in energy taxes might be more tolerable.

Possible new taxes on energy would include an oil import fee, a windfall profit tax on decontrolled natural gas, and a general energy excise tax (see Table 1). An oil import fee would increase directly the cost of imported oil, thereby conferring a relative advantage on competing sources of energy—including domestic oil, gas, and coal. Domestic energy production and prices and the profits of domestic energy producers would increase, while foreign suppliers would likely have to absorb part of the tax to compete. The increased cost of energy would add somewhat to inflation and unemployment. Each $1 per barrel of import fee would raise about $2 billion per year in revenues, both directly and through higher windfall profit taxes, but the reduced employment and increased inflation would cost the federal government about 25 percent as much in increased outlays and reduced revenues from other taxes.

Price controls on natural gas are widely held to have caused shortages and misallocations. Immediate and full decontrol of natural gas would go a long way toward eliminating those inefficiencies, but it would also result in windfalls for the owners of supplies of low-cost gas. Those windfall profits could be taxed in the same fashion as under the oil windfall profit tax. Such a tax could raise from $2 billion to $5 billion in 1984, but if the tax was limited only to the profits from the acceleration of decontrol before the scheduled limited decontrol on January 1, 1985, revenues would drop sharply after the after the first year. An alternative would be a simple excise tax on natural gas; such a tax would raise about $1 billion per year for every 10 cents on each 1,000 cubic feet. Such a tax would discourage the use of natural gas, however, which might or might not be in keeping with national energy policy, and it would also burden homeowners hard hit by raising heating bills.

TABLE 1.—ESTIMATED REVENUE GAINS FROM NEW OR INCREASED EXCISE TAXES

[By fiscal year, in billions of dollars]

| Options | 1984 | 1985 | 1986 | Cumulative 3-year increase |
|---|---|---|---|---|
| Impose oil import fee ($2 per barrel) | 3 | 4 | 4 | 12 |
| Impose broad-based tax on domestic energy (5 percent of value) | 11 | 17 | 19 | 47 |
| Impose tax on domestic and imported oil ($2 per barrel) | 6 | 9 | 9 | 23 |
| Impose excise tax on natural gas (30 cents per 1,000 cubic feet) | 2 | 3 | 3 | 8 |
| Increase gasoline excise tax (5 cents per gallon) | 3 | 4 | 4 | 11 |
| Extend doubling of cigarette excise tax beyond 1985 [1] [2] | | | 2 | 2 |
| Continue 3 percent excise tax on telephone service beyond 1985 [1] [3] | | | 1 | 1 |
| Double excise taxes on alcohol [1] [4] | 2 | 4 | 4 | 10 |

[1] The revenue effects are net of income tax offsets. Excise tax increases lower income tax revenues because they can be deductible business expenses and because, unless monetary policy is fully accommodating, they lower taxable incomes throughout the economy. Taking both of these effects into account, and assuming an economy-wide marginal tax rate of 25 percent, results in a net revenue effect that is 75 percent of the gross effect.

[2] The doubling of the cigarette excise tax expires Oct. 1, 1985, under current law. The extension beyond 1985 assumes no break in tax collections.

[3] The telephone excise terminates Dec. 31, 1985, under current law.

[4] The effective date is Jan. 1, 1984.

Sources: Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options" (February 1983), pp. 253 and 258.

Note.—Details may not add to totals because of rounding.

A general tax on all energy sources could be formulated in several ways; it could be a tax on each unit of production (tons of coal, barrels of oil, cubic feet of gas), or on the value or price of the energy produced (ad valorem tax), or on the heat content of the fuel (generally measured in British thermal units, or Btu). A 5 percent-of-value tax on all U.S. energy consumption would raise $15 billion to $20 billion per year in revenues.

An existing energy excise tax that could be increased is that on gasoline. Each one-cent increase in the federal excise tax on gasoline raises about $1.1 billion in revenues, though offsetting income tax reductions would reduce the net revenue increase by about 25 percent. While the gasoline excise tax increase would be administratively easier than creating a new tax, it would repeat the increased burden of the recent increase and impinge somewhat on a revenue source heavily used by the states. It would also have differing regional impacts.

Other excise taxes could also be increased. The Tax Equity and Fiscal Responsibility Act increased the 8-cents-per-pack tax on cigarettes to 16 cents per pack through September 30, 1985; extending that increase would yield revenues of about $1.7 billion per year. The 16-cents-per-pack tax represents about 18 percent of the current cost per pack, still less than the 37 percent of the cost per pack that the 8 cent excise represented in 1951 when it was last raised prior to TEFRA.

The TEFRA increase in the telephone service excise tax from 1 to 3 percent for calendar years 1983–1985 could be extended. The revenue yield would be $2 billion to $3 billion per fiscal year.

Federal excise taxes on alcohol have not been increased since 1951. Doubling those excises would follow the pattern of the tobacco excises set in TEFRA. Distilled spirits are currently taxed at $10.50 per gallon; doubling that tax would raise about $2.7 billion per year. Doubling the excises on beer and wine combined would raise about $1.3 billion per year. At present, beer and wine are both taxed significantly more lightly than distilled spirits as a percentage of retail price, so differential treatment might be called for.

### POSSIBLE BASE-BROADENING OPTIONS

The Congress could also raise revenues by eliminating or reducing several tax expenditure provisions. This base-broadening approach was used last summer in TEFRA. Broadening the tax base in this way can make the economy more efficient, by reducing the federal government's role in determining the allocation of resources and increasing the influence of the free market. It can also make the tax system more fair, by treating incomes form different sources more alike. Below is a list of possible options for base-broadening; a much more extensive list can be found in CBO's February 1983 report on reducing the deficit.

*Repeal Percentage Depletion Allowance for Oil and Gas.* Independent oil and gas producers are allowed to use percentage depletion instead of cost depletion to recover the costs of discovery and development of oil and gas wells. Eliminating percentage depletion would increase federal revenues by $0.9 billion in fiscal year 1984 and by about $4.5 billion in fiscal years 1984–1986 (see Table 2). The provision was intended to encourage domestic energy production by relatively small-scale producers, but the sharp rises in oil and gas prices in recent years may provide sufficient incentive to potential producers.

*Repeal Expensing of Intangible Drilling Costs for Oil and Gas.* Taxpayers engaged in oil and gas drilling may deduct the amount they spend on intangible drilling costs in the year the expenditure is made, instead of amortizing the amount over the life of the well. While TEFRA cut back this provision somewhat, repealing expensing entirely would increase federal revenues by $2.6 billion in fiscal year 1984 and by about $11 billion in fiscal years 1984–1986. Proponents of repeal argue that high oil and gas prices as well as the other tax incentives available to the industry provide sufficient encouragement; opponents want to retain the provision in order to help promote a more independent national energy supply.

TABLE 2.—ESTIMATED REVENUE GAINS FROM BROADENING THE TAX BASE

[By fiscal year, in billions of dollars]

| Options | 1984 | 1985 | 1986 | Cumulative 3-year increase |
|---|---|---|---|---|
| Repeal percentage depletion allowance for oil and gas | 1 | 2 | 2 | 4 |
| Repeal expensing of intangible drilling costs for oil and gas | 3 | 4 | 4 | 11 |
| Limit nonbusiness, noninvestment interest deductions to $10,000 | 1 | 2 | 2 | 4 |
| Lengthen the building depreciation period to 20 years | ([1]) | 2 | 4 | 6 |
| Repeal net interest exclusion |  | 1 | 3 | 4 |
| Require full basis adjustment for the investment tax credit | ([1]) | 1 | 2 | 4 |
| Tax nonstatutory fringe benefits | 1 | 1 | 1 | 3 |
| Limit charitable deductions for nonitemizers to $100 |  | 0 | 2 | 2 |
| Tax some employer-paid health insurance: |  |  |  |  |
| Income tax | 3 | 5 | 6 | 14 |
| Payroll tax | 1 | 1 | 2 | 4 |
| Freeze estate and gift credit at exemption equivalent of $275,000 |  | 1 | 1 | 2 |
| Eliminate deductibility of State and local sales taxes | 1 | 6 | 6 | 13 |

[1] Less than $0.5 billion.

Sources: Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options" (February 1983), pp. 250–51.

Note.—Details may not add to totals because of rounding.

*Limit Consumer and Mortgage Interest Deductions to $10,000.* Limiting all consumer and mortgage interest deductions to $10,000, paralleling the limit on investment interest deductions, would affect one percent of all taxpayers and would raise $0.6 billion in fiscal year 1984 and about $4 billion in fiscal years 1984–1986. The proposal would limit deductions of all interest payments on home mortgages, auto loans, installment purchases, credit card carryovers, and other consumption borrowing.

*Lengthen the Building Depreciation Period to 20 Years.* Since the enactment of ERTA, both new and newly purchased buildings can be depreciated over 15 years using the 175 percent declining balance method. Lengthening the tax life for structures from 15 to 20 years would raise $0.4 billion in fiscal year 1984 and about $6 billion in fiscal years 1984-1986. While a longer period might introduce some distortion of investment allocation, it would more closely approximate a structure's useful life.

*Repeal Net Interest Exclusion.* A tax exclusion of up to $450 of net interest income will be available to individuals starting in 1985 (up to $900 for joint returns). Repeal of the exclusion would raise about $4 billion in fiscal years 1985-1986. The provision was enacted to reduce taxes on savings, but saving could also be encouraged—at a further revenue gain—by restricting existing tax incentives for consumer borrowing.

*Require Full Basis Adjustment for the Investment Tax Credit.* To reduce the overlap of benefits from accelerated depreciation and the investment tax credit, in TEFRA, the Congress limited the depreciable basis of an asset to its price minus 50 percent of the eligible investment credit. A full basis adjustment would restrict depreciation to a firm's net cost of the asset—90 percent in the case of the regular investment credit. If applied to investments in machinery and equipment, this proposal would increase federal revenues by $0.3 billion in fiscal year 1984 and by about $4 billion in fiscal years 1984-1986.

*Tax Nonstatutory Fringe Benefits.* If the Congress permitted the Internal Revenue Service to issue regulations governing the taxation of most fringe benefits (including, for example, private use of a company car, reduced-price meals, and discounts on employers' products), the revenue gain would be $0.6 billion in fiscal year 1984 and about $3 billion in fiscal years 1984-1986. The present exemption encourages employees to bargain for nonwage forms of compensation; this shrinks the tax base and misallocates resources. Taxing certain fringe benefits, however, could be complicated and costly.

*Tax Some Employer-Paid Health Insurance.* Employees do not pay income taxes or payroll taxes on income received in the form of employer-paid health care coverage. One proposal to limit the present exclusion treats amounts exceeding $160 a month for families and $65 a month for individuals as taxable income. This would increase income tax revenues by $2.7 billion in fiscal year 1984 and by about $14 billion in fiscal years 1984-1986; it would increase payroll tax revenues by $0.8 billion in fiscal 1984 and by about $4 billion in fiscal years 1984-1986. Many observers feel that the exclusion encourages overuse of health care services, thereby driving up health care costs.

*Eliminate Deductibility of State and Local Sales Taxes.* Eliminating the itemized deduction for state and local sales taxes would increase federal revenues by $0.9 billion in fiscal year 1984 and by about $13 billion in fiscal years 1984-1986. While sale taxes reduce taxpayers' net income, they are the kind of small, uniform, and predictable expense that is implicitly taken into account when the zero bracket amount, personal exemptions, and general tax rates are established.

CONGRESSIONAL BUDGET OFFICE
U.S. CONGRESS
WASHINGTON, D.C. 20515

Alice M. Rivlin
Director

JUL 28 1983

Honorable Robert J. Dole
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Enclosed are my responses to your written questions on tax expenditures, contained in your letter of June 29, 1983, in reference to my testimony of June 28 before the Senate Finance Committee.

I hope that these answers are helpful in your deliberations. Please contact me if I can be of any further assistance.

Sincerely,

James Blum

for

Alice M. Rivlin
Director

1. We have already had hearings on the Administration's proposal to cap the exclusion for employer-provided medical expenses.

CBO has also listed this idea as a revenue raiser. Do you have an opinion on the level at which the exclusion should be capped?

If the exclusion for employer-provided medical expenses is to be capped, choosing a level must reflect a tradeoff between competing objectives. A lower level would lead to a larger revenue gain and a greater impact on the medical care system. On the other hand, lower levels mean higher additional tax payments by individuals.

Some have suggested setting the cap at the cost of an "efficient" medical care plan. This is not possible, however, because there is no consensus on the structure of such a plan, and the premium for any standard health insurance policy varies substantially from one part of the country to another.

2. There is no cap on the exclusion for employer-provided dependent care. Presumably this could mean that the cost of a live-in "Nanny" could be paid entirely with pre-tax dollars if an employer offered this statutory fringe benefit. Should we consider a cap on the exclusion for dependent care?

The exclusion for employer-provided dependent care is analogous to the child and dependent care tax credit, which has a cap. The rationale for the cap is that child and dependent care can be expanded beyond a basic level virtually without limit as a form of consumption; one could imagine sending a child to an expensive tennis camp that peforms the function of child care during the parents' work day, for example. Allowing the credit without limit would subsidize such consumption above and beyond basic but perfectly satisfactory dependent care.

The exclusion for employer-provided dependent care should in principle have a cap for exactly the same reason; in your example, the live-in "Nanny" could go well beyond day care, even to in effect one-on-one private education. Tax subsidization of such activities would probably violate widely-held standards of fairness, and also induce misallocations of resources.

The only argument against such a cap is that it could become extremely complicated. Most employer-provided dependent care, at least according to anecdotal evidence, is supplied in dedicated space within the building or building complex where the parent works. This means that the cost of providing that dependent care really includes an implicit space rent, the cost of light, heat, and cooling, and a share of any other fixed costs associated with operating the building or buildings. In most instances such costs are small and could be ignored, but ignoring them does leave an avenue for abuse through an extravagant physical plant. The dependent care expense that most people would think of first would be the wages of the dependent care provider, and a cap would have to cover all labor inputs to the dependent care process to prevent abuse; it would be necessary, as an example, to include under the cap the cost of workers who spend only part of their time providing dependent care.

Of course, these safeguards would make little difference in the vast majority of instances; most employer-provided day care is a basic product. If the purpose of a cap is to prevent abuse as well as to raise revenue, however, there must be some regard for the potential for circumventing the cap to perpetuate abuse.

How about an overall cap on statutory fringe benefits?

An overall cap on statutory fringe benefits would perform three useful functions: it would limit the allocationally distorting incentive to divert employee compensation into nontaxable forms; it would permit more equitable treatment of taxpayers with generous fringe benefits and those without; and it would raise revenue.

The precise distribution of statutory fringe benefits among taxpayers is not known, and so the revenue implications of any particular overall cap could only be estimated. (The Joint Committee on Taxation has already prepared some estimates.) In general, however, a cap could be set at a high level to establish a precedent without impinging on many taxpayers or raising much revenue; or it could be set lower to play an immediate and significant role in a revenue-raising program. The cap could be set as a fraction of cash compensation, though an additional dollar cap could be added to prevent the permissible level of tax-free fringe compensation from growing beyond some point as taxable cash compensation grows.

The major complications with the cap would be defining income and coordinating with existing caps. The actual income to a taxpayer under a pension plan would be difficult to determine. A taxpayer who is not yet vested under his company's plan arguably receives no income at all even though his company might make a contribution on his behalf. The contribution for a vested employee may or may not equal the employee's true accrual of pension rights, depending on whether the plan is fully funded. Pension rights also depend on the plan's provisions for a worker's survivors in the event of his or her premature death, which is, of course, a hypothetical circumstance. Other questions might be raised with respect to valuation of health or life insurance contributions.

Further, there are already caps on two statutory fringe benefits: employer premiums on employee life insurance are tax-exempt to the employee only to the extent of $50,000 of coverage; and pension contributions are tax-exempt only if they meet nondiscrimination requirements, and then only up to a maximum limit for top-heavy plans. Any formula for an overall cap would have to coordinate with these individual limitations. A question might arise if a particular employee had less than the overall maximum for the tax-free fringe benefits, but had reached the cap for life insurance or pension contributions and wanted more of that item. Another knotty problem might conceivably arise if a taxpayer's pension limit under a generous but nondiscriminatory formula exceeded his overall limit.

3. The CBO Spending and Revenue Options report suggests placing an overall limit on itemized deductions and credits.

Could you tell us what itemized deductions would be most affected at various income levels?

Historical data suggest that the itemizers with the lowest incomes make the heaviest relative use of medical deductions. As incomes increase, interest and state and local tax deductions become more prominent; these deductions are predominant among middle-income homeowners. At higher income levels, charitable contributions become relatively important.

Of course, the published historical data provide only total itemized deductions for each income group, which are, in a sense, averages. An individual taxpayer with large itemized deductions in any one year might have an extraordinary medical expense, a large mortgage, a large contribution, or any other large item.

4. You also include a limitation on nonbusiness, noninvestment interest deductions to $10,000.

Would such a limit, in your opinion, have an adverse impact on economic recovery?

A $10,000 limitation on nonbusiness, noninvestment interest deductions would affect only about 1 percent of taxpayers and would raise only $4.4 billion through fiscal 1986 (if effective on January 1, 1984). It is unlikely that a step of such limited magnitude would have any measurable fiscal effect on the economic recovery; nor would it by itself nearly meet the revenue targets in the first concurrent budget resolution. If such a limitation was part of a deficit reduction program, however, it could prolong the recovery by reducing the pressures on monetary policy and on interest rates, though it would also reduce the net fiscal stimulus embodied in the current federal budget deficit.

5. CBO has listed repeal of the net interest exclusion as a potential revenue raiser. Wouldn't repeal add to the consumption bias of the Internal Revenue Code?

Considered in isolation, repeal of the net interest exclusion would increase the consumption bias of the Internal Revenue Code—that is, repeal would decrease both the after-tax reward to lending and the after-tax cost of borrowing. Repeal is sometimes suggested as a revenue raiser, however, because it is arguable whether the limited impact of the provision on net saving would be worth its revenue cost, and because other provisions in the law and potential alternatives make the need for the exclusion uncertain.

The net interest exclusion might have a very limited effect on net saving. It applies only to interest income, while saving can also take forms that yield dividends or rent or capital gains; there is at least some question whether a subsidy limited only to interest is appropriate. The design of the exclusion also makes it a windfall rather than a marginal incentive for the taxpayers who do most of the nation's saving. Home mortgage interest expense does not count against the exclusion; if the concern is the overall consumption bias of the tax code, then this feature of the exclusion, which encourages borrowing by the vast majority of marginally affected taxpayers, is certainly questionable.

Further, the need for the net interest exclusion might seem far less pressing in light of other actual or potential features of the tax law. Any reduction of marginal tax rates decreases the tax burden on interest income and the tax subsidy for interest expense, and the recent 23 percent across-the-board reduction of marginal rates was a significant step in that direction. Finally, repeal of the tax deductibility of some or all interest on consumer borrowing in combination with repeal of the net interest exclusion would also encourage net saving and would raise revenue rather than lose revenue.

Is there sufficient revenue involved to put much pressure on raising tax rates?

Repeal of the net interest exclusion (which takes effect on January 1, 1985) would raise $1.1 billion in fiscal 1986. Obviously, this step could not by itself fulfill the requirements of the first concurrent resolution or significantly narrow the budget deficit. Like every other item in the *Reducing the Deficit* list, it is a potential part of a deficit-reduction program rather than a program in itself.

6. CBO has also suggested that we might want to consider elimination of the income averaging provisions. What would be the rationale for this?

What would be your view on limiting averaging to 2 years, for example, rather than repeal?

The rationale for repeal of income averaging is that the benefits of the existing provision go to a great extent to other than the intended beneficiaries. Income averaging was designed to cushion the tax burden exacted by a progressive rate structure on episodic incomes that sometimes reward lengthy periods of labor—such as might be received by an author or an inventor, or by an entrepreneur who built up a business over a period of years. Continuing inflation, however, has enabled upwardly mobile wage and salary workers to routinely qualify for income averaging, even though their incomes might show a uniform increase rather than fluctuation.

Repealing income averaging would end the unintended benefit to those with predictable but growing incomes, but it would also end the intended benefit to those with unpredictable and fluctuating incomes. Limiting the averaging period to 2 years would be a compromise solution, though it may restrict the intended benefits more than the alternative mentioned in CBO's *Reducing the Deficit*—requiring that current year income exceed that of the base period by 40 percent rather than 20 percent before averaging is permitted.

Recent developments in tax and economic policy cut both ways on income averaging repeal. Because the extra tax burden on fluctuating incomes depends on the steepness of the tax rate schedule, the flattening of the schedule through the 23 percent tax rate cut might suggest that income averaging is less urgently needed and could be repealed. On the other hand, the recent slowdown of inflation may itself sharply reduce the unintended benefits of income averaging by slowing the nominal rate of growth of predictable wage and salary incomes. This would mean that income averaging might be more efficient in delivering relief to those with fluctuating incomes, and might therefore be retained.

7. Are the tax credits for rehabilitating older buildings effective? Are they sufficiently targeted?

Current law provides a 15 percent credit for rehabilitation of nonresidential buildings 30 to 40 years old, and a 20 percent credit for those over 40 years old. Structures certified as historic and used as income-producing property are eligible for a 25 percent tax credit so long as the renovation is judged to preserve the historic features. The depreciable basis of a renovated structure must be reduced by the full amount of the 15 and 20 percent credits, but by only half the amount of the 25 percent credit.

The tax credits substantially reduce the cost and therefore raise the profitability of rehabilitation. This is true even after netting out the basis adjustment. Under typical conditions, the basis adjusted 15 percent credit yields a 10 percent cost reduction, the 20 percent credit yields a 14 percent cost reduction, and the half-basis adjusted 25 percent credit yields a 21 percent cost reduction.

Observers of rehabilitation activity report increased activity in 1982, although it is premature to determine the portion attributable to ERTA's incentives. Industrial and commercial rehabilitation grew 17 percent in 1982 while similar new construction declined slightly. A recent *Business Week* (April 4, 1983) reports numerous cases of old factories being converted to office, retail, and residential use, and a realty financial advisor quoted there stresses the importance of tax incentives in stimulating the conversions.

Certified historic rehabilitation grew particularly strongly in 1982. From 1976 through 1981 under the pre-ERTA incentive, a total of 3,138 projects qualified for benefits; in 1982 alone, 1,802 more projects qualified. Furthermore, applications for determination of historical significance, the first step in qualifying for tax benefits, rose four- to eight-fold. Effects on historic rehabilitation of the TEFRA-imposed partial basis adjustment are yet to appear.

If the tax credits are intended broadly to encourage rehabilitation at the expense of less costly new construction, the credits must be available broadly, as are the 15 and 20 percent credits. If the credits are intended to preserve a small number of outstanding architectural examples, the credits can be narrowly focused and controlled, like the historic credit.

The 15 and 20 percent credits are broadly available because roughly half of all business structures are 30 or more years old. Probably well over half of all rehabilitation activity is concentrated on these structures simply because younger ones are less likely to need rehabilitation.

In contrast, the historic credit is narrowly focused. Buildings must first be judged by local and Interior Department panels as having historic value and then the rehabilitation separately must be certified as preserving the historic value. As of 1981, there were only 25,000 listings on the National Register of Historic Places, although some listings were historic districts with many structures. However, the number of registered buildings has been growing rapidly.

The historic certification process provides a means for targeting tax credits and therefore limiting revenue losses. Imposition of a limit on the number of structures certifiable in a year would further control revenue losses from the 25 percent tax credit. However, as long as the nonhistoric rehabilitation credits remain so lucrative, restricting just the historic credit would not greatly limit revenue losses from the rehabilitation tax credits.

8. CBO lists elimination of the tax exemption for small issue industrial development bonds as a revenue option. Why aren't the limitations enacted last year sufficient?

In accordance with TEFRA, small issue industrial revenue bonds (IRBs) will be eliminated on December 31, 1986. An earlier sunset date would, of course, result in some revenue gains. If the bonds were eliminated at the end of 1983, revenue gains over the period from fiscal year 1984 to fiscal year 1988 would amount to $3.7 billion.

As an alternative to an earlier sunset date, further restrictions on the use of IRBs might make sense, particularly in view of the possibility that the scheduled date could be extended or repealed. Under TEFRA, firms that finance projects conventionally can take accelerated depreciation; firms that use tax-exempt financing are limited to straight-line depreciation over the ACRS recovery period. This limitation will have little effect on the volume of small issue IRBs. At most, the volume of small issues will be 20 percent lower than it might have otherwise been. More likely, the reduction would be no more than 10 percent because IRBs, coupled with straight-line depreciation over the ACRS recovery period, provide significantly greater benefits to private firms than accelerated depreciation coupled with conventional financing. For three- and five-year equipment, the benefits exceed expensing. As a result, the revenue gains from the TEFRA limits will be modest until 1987, when small issues will no longer be permitted. The other restrictions in TEFRA, which include primarily public hearings and approval of bond issuances by elected officials, will also not significantly reduce the volume of issues.

In 1982, the Senate Finance Committee reported out a bill that would have had a greater effect on the volume of small issues than the provisions in TEFRA. The Administration proposed even more stringent limits. All of these proposals would have required firms using IRBs to depreciate their property over longer recovery periods than the 3 to 15 years permitted under current law. A bill recently introduced in the House—H.R. 1635—would require firms using tax-exempt financing to depreciate property over periods ranging from 5 to 25 years. The Senate Finance Committee approved a similar measure last year. The effect of such a provision would be to reduce substantially the use of IRBs for real property acquisition. For a comparison of the benefits under current law with those under alternative proposals, see the attached table, which was included in testimony before the Committee on Ways and Means on tax-exempt financing for private purposes, June 15, 1983. A copy of the full testimony is enclosed, together with a report on the use of small issue IRBs during the past two years.

### PRESENT VALUE OF AFTER-TAX SAVINGS FROM ALTERNATIVE METHODS OF FINANCING AND DEPRECIATING A $10 MILLION INVESTMENT IN EQUIPMENT OR REAL PROPERTY [1]

[In thousands of dollars]

| Tax provision | 3-year equipment [2] | 5-year equipment [3] | 10-year equipment [4] | 15-year public utility property [4] | 15-year real property [5] |
|---|---|---|---|---|---|
| Expensing | 4,600 | 4,600 | 4,600 | 4,600 | 4,600 |
| ACRS, ITC, and conventional financing | 4,097 | 3,875 | 3,310 | 2,860 | 3,070 |
| Current law alternative (straight-line depreciation over ACRS recovery period) | 4,775 | 4,752 | 4,359 | 4,035 | 3,715 |
| H.R. 1635 alternative (straight-line depreciation over 5- to 25-year recovery periods) | 4,439 | 4,353 | 3,888 | 3,653 | 3,051 |
| Administration's 1982 proposal (straight-line depreciation over 5- to 35-year recovery periods) | 4,439 | 3,920 | 3,259 | 3,022 | 2,649 |

[1] Assumes a 3 percentage point differential between tax-exempt and taxable interest rates and a 46 percent corporate tax rate. The terms of the bonds vary, as indicated, with the type of property being financed. Tax savings are stated in present value terms, using a 10 percent discount rate. Present value discounting is a procedure used to assign a value to funds that will be received at specific future dates. It is designed to take into account the fact that the promise of funds in the future is less valuable than having the money currently in hand.

[2] Assumes a 7-year bond term.

[3] Assumes a 10-year bond term.

[4] Assumes a 15-year bond term.

[5] Assumes a 20-year bond term. The ITC is inapplicable. Low-income housing is excluded.

Do IRBs increase the amount of investment or just shift investment dollars around?

Since not all projects are eligible for IRB financing, the bonds clearly affect the allocation of investment dollars. A general business tax cut would have less specific effects.

IRBs lower the cost of capital for firms qualifying to use the bonds. This may result in increases in investment and consequently in GNP, provided that new savings become available to finance new investment. The critical element in the chain of economic responses to the issuance of IRBs is whether or not savings increase, permitting increases in overall investment to go forward. Such increases may occur under two conditions:

(1) If there is some initial unemployment, expanded investment plans may themselves stimulate increased saving. Firms planning new projects order new equipment or hire construction firms, and the increased wages and profits that result give rise to increases in saving. Moreover, the "multiplier" effects may expand incomes and savings further. This process would not go forward, however, if the federal government offset the expansionary effects of the increase in IRB supplies with increases in other taxes or reductions in other spending programs.

(2) Even with no significant initial unemployment, an increase in saving may occur as a direct result of the tax exemption for interest on the new IRBs. The tax exemption represents an increase in the after-tax rate of return to saving, which may induce individuals to increase the portion of income that they save, thus expanding the total supply of savings.

If, however, few unemployed resources are available and if the sensitivity of the savings rate to the after-tax rate of return is low, investments may be financed by savings attracted away from other projects; in that case, there may be no net increase in investment.

Unless the increase in saving that is stimulated by the tax exemption is large enough to finance the entire increase in outstanding IRBs, there is likely to be an increase in the interest rates on other borrowing instruments that will partially choke off new investment. Under these conditions, some of the funds invested in new IRBs must be attracted away from other financial assets—other tax-exempt bonds, fully taxed bonds, bank accounts, corporate stocks, mortgages, or other assets. When this happens, interest rates on these alternative financial assets may rise, increasing the cost of investment and at least partially offsetting the original investment-stimulating effects of the expansion in IRB supplies.

9. CBO has also listed repeal of the parental personal exemption for students as a revenue option.

What would be the rationale for this?

Families with children who are students but who also earn more than $1,000 can claim personal exemptions for them, even though they file their own tax returns. Children who earn more than $1,000 but are not students cannot be claimed as dependents by their parents. The extra exemption for parents of students is therefore a kind of subsidy for education, a subsidy some would argue is not very efficient. The extra exemption is worth the most to taxpayers in the highest tax rate brackets, who need the subsidy the least. From this viewpoint, repeal would foster tax equity while having only a limited impact on the availability of funds for education.

10. CBO's Revenue Options report discusses reduction in the credit for incremental research expenditures. Do you have any ideas for a more efficient R&D incentive?

We have no suggestions at this time. Subsidization of R&D through the tax system is necessarily complicated by problems of objectives, measurement, and administration. Therefore, even though the current law R&D tax credit may be unsatisfactory in several respects, it does not follow that there are simple ways to improve it.

There are several features in the law intended to reduce the revenue loss and thereby make the 25 percent R&D income tax credit more efficient. The credit is restricted to applied research and development in a firm's current lines of trade or business. Only incremental research in excess of the average for a three-year base period qualifies, but the credit may be claimed for no more than half of total expenditures. Sixty-five percent of amounts paid for contract research or basic research performed by a university on a written agreement with a corporation qualify.

These restrictive features, however, also reduce or eliminate the incentive for performing some forms of R&D. The requirement that R&D expenditures apply to a trade or business in which the firm is already involved prevents some new firms from taking part, and prevents existing firms from claiming the credit for R&D used to explore new fields. The restriction of the credit to incremental R&D above the average over a three-year base period eliminates the incentive for firms with ongoing R&D projects to continue at the same level rather than cut back. The credit generally does not support basic research, or supports it only at a reduced rate. Loosening any of these restrictions to encourage more R&D, however, would add to the revenue loss.

Another efficiency concern is the difficulty of identifying true R&D. Some fear has been expressed that ordinary operating expenditures will be classified as R&D for purposes of claiming the tax credit, whether to avoid taxes or through confusion as to whether a particular expense qualifies. There is no way to guarantee that such misclassification will not occur.

In the final analysis, subsidization of R&D expenditures through the tax system must either be restrictive, to minimize the revenue loss, or generous, and therefore expensive. If the Congress determines that applied R&D is a fitting object for government subsidization (and the case for subsidization of applied R&D, with its likelihood of profitability, is probably weaker than that for more speculative basic research), then some inefficiencies are probably inevitable.

11. CBO also notes the possibility of limiting the tax deduction for business entertainment and meals to 50 percent of the amount spent.

Presumably there is some difficulty for both taxpayers and the IRS in deciding whether entertainment costs are ordinary and necessary business expenses. Would a 50 percent limit help in this area?

In virtually all cases, business entertainment and meal expenditures are income to the employee, in that they substitute for expenditures that the employee would otherwise make on his own behalf. In many cases, an expense account is considered a nontaxable salary supplement. Because such expenditures are also deductible to the employer, the employee has an interest in converting salary income into entertainment and meals expenditures, and employers are indifferent. As a result, there is a misallocation of resources toward compensation in the form of entertainment and meals expenses.

The ideal solution would be to make taxable the part of entertainment and meals expenses that substitutes for cash compensation. This solution is not feasible, because it is impossible to determine how much of such expenses in fact substitutes for salaries. An employee may consume an expensive expense account meal that he would not contemplate purchasing out of his own aftertax income, and so including the total price of that meal in his taxable income would be unfair. Similarly, an employee on business may take a client to a sporting event in which he has little or no interest, and so including the admission price in his taxable income would again be unfair.

The alternative solution proposed in CBO's *Reducing the Federal Deficit* was to reduce the firm's deduction to one-half of employee meal and entertainment expenses. The purpose of this approach is to offset the incentive in current law to shift income from cash compensation to meal and entertainment expenses because of the nontaxability of such expenses to both employer and employee. If such a restriction was enacted, firms could be expected to consider their meal and entertainment expenses more critically, restricting such expenses more than presently to those that actually have a business purpose.

This is an imperfect solution to the problem. Any actual income resulting from meal and entertainment expenses is clearly the employee's rather than the employer's; thus, it ideally should be taxed at the employee's marginal tax rate, rather than at the employer's as provided here. Further, if a particular meal or entertainment expense in fact is productive, the absence of a full deduction may inhibit a firm from undertaking it. This policy option and any other workable solution to the meal and entertainment problem would fall short of the ideal, and must be judged by the seriousness of its flaws in comparison to the distortions in the current tax treatment.

The CHAIRMAN. Thank you very much, Dr. Rivlin.

I think, under the early bird rule, Senator Moynihan was first here.

Senator Moynihan, do you have any questions?

Senator MOYNIHAN. Not so much a question, Mr. Chairman, but in welcoming, once again, Dr. Rivlin to this hearing room I would ask if she wouldn't want to reflect a little bit on the situation that brings us here, which is the enormous deficit—$200 billion, as far as the eye can see, according to Mr. Stockman. I don't know if Mr. Stockman read that briefing book that the Carter administration put together or not, but——[Laughter.]

There is just something, it seems to me, worth discussing. Has there been a great failure in our tax policy? Did this committee and this Congress act in 1981, using assumptions that have proven themselves to be flawed?

Alas, with any luck, Dr. Rivlin, you are going to be set free one of these days, although I'm sure there are three people in this room whose job is to see you don't suddenly dash off to Union Station and report that you have left the Budget Office for good. But what do you think we did in 1981 that led us to such a travail as we are going to have in this committee? We have been instructed to increase taxes by the budget resolution. One-quarter of the committee announced by letter this morning that under no circumstances would they follow the instruction, and the rest of the committee is conspicuously absent to hear the various possibilities that you present. Do you think we made a great mistake in 1981?

Dr. RIVLIN. Oh, I think there is room for apportionment of blame in a lot of directions, Senator. What has happened since 1981 is, of course, that the Congress cut taxes without cutting spending commensurately, and that's a way to guarantee a large deficit.

Senator **Moynihan**. But wait. We were told that there would be no loss of revenues from the reduction of rates; right?

Dr. **Rivlin**. No. To give the administration it's due, it never made that extreme claim.

The **Chairman**. Some of our Members did.

Senator **Moynihan**. Some of our Members did. I didn't say anything.

Dr. **Rivlin**. Certainly, the economic estimates on which the Congress was proceeding in early 1981 proved extraordinarily overoptimistic. Some of us pointed that out at the time. It should be noted, though, that even the Congressional Budget Office was more optimistic than in fact was justified by events. The economy has not taken a great leap forward under the impact of the new policies of 1981; indeed, we suffered, as you all know too well, a deep recession, from which we are only now recovering.

But the basic problem, I think, is that everybody wants more from their Government than they are willing to pay for, and the tax cut was indeed too large if spending cuts were not undertaken at the same time.

Senator **Moynihan**. Well, all right. But, Dr. Rivlin, I am a little surprised at you. You know the role of ideology in economics as well as in other things; you know perfectly well what the Laffer Curve asserted. And in May 1980, in Flint, Mich., the President of the United States, as he is now, said, "We would take the increased revenues from this 'tax' decrease and use it to rebuild our defense capabilities." Now, you know he said that; right? And it was said in this committee and everywhere else.

The **Chairman**. I think that was Jack Kemp.

Senator **Moynihan**. I think somebody from my State said that. The point I just want to make is that there was a doctrinaire ideological assertion of an empirical economic theorem, which was wrong. Is that right?

Dr. **Rivlin**. It was not reasonable to expect that revenues would rise when tax rates were cut. That is correct.

Senator **Moynihan**. Alice, you have been around here too long. I think you need a sabbatical. [Laughter.]

And then you can really tell us what you think about it all. [Laughter.]

Thank you very much. And you know the regard and affection with which you are held by this committee.

Dr. **Rivlin**. Thank you, Senator.

The **Chairman**. Senator Danforth.

Senator **Danforth**. Dr. Rivlin, I would like for you to comment on an observation that I would make.

We have gone through an agonizing couple of years of budget cuts on specific items in the budget, most of which have been very controversial. Last year we went through an agonizing process of trying to improve our ability to collect taxes in kind of an ad hoc, very specific way. We now have before us the possibility of loophole-closing measures, and you furnished us with a number of them, each of which would be very, very controversial.

I think that the battle might be worth fighting; but my proposition to you is this: Regardless of what projections we use for an economic recovery, we are likely to have deficits of at least $150 billion a year, as far as the eye can see, unless we are willing to operate in a very broad-based way, unless we are willing to put together a package which both increases revenue and controls the growth rate of the entitlement programs.

In other words, while I think that it's worthwhile going through an exercise of trying to close loopholes, I think the problem with that kind of approach is that it tends to say that there is somebody else out there who we can nail—there is somebody else's loophole we can close; it's all going to be very painless, and we can come up with enough odds and ends to get the deficits down to a manageable level.

But my proposition to you is that, regardless of what kind of job we do in closing loopholes, and regardless of what kind of job we do in halting waste, fraud, and abuse, and all the things people want to sift out of the budget, we are going to have $150-plus deficits unless we have a very broad-based approach which includes a containment of the growth rate of the entitlement programs.

Dr. Rivlin. I agree with the basic proposition, Senator. There is no painless way out of this situation, either on the tax side or on the spending side.

As you look ahead on the spending side, the major growth items are medicare, social security, and defense. I think that you can't solve the spending problem, in the sense of controlling the rate of growth in Government spending, unless you take a hard look at the defense spending increase—which you have just done in passing the budget resolution—and at the entitlement increases as well. There isn't enough left after that; the rest of the budget is essentially not growing.

On the tax side, there are no easy answers, either. I think that there are basically two approaches that you can take to raising more revenue other than just raising rates in the income tax, by a straight rate increase or a surtax, which would strike me as probably not the most desirable.

I think you should take this opportunity to look at the tax system and try to restructure it in one of two ways: One would be a major base-broadening effort that would give you a fairer income tax; the other would be a shift toward consumer taxation. But none of those things are going to be easy. There is no free lunch.

Senator Danforth. It is also true, isn't it, that regardless of what we do on the tax side, we are going to have to do something on the spending side, as well? In other words, we are going to have to put together a package which is politically intolerable, that is very, very difficult for us as politicians to put together; but it seems to me that the first thing we have to do is to face up to the truth, and the truth is that there is no laundry list which is going to come up with enough numbers. That's not to say that the laundry-list approach isn't worth doing; but there is no laundry list in either taxation or spending which is going to come up with enough money to get that deficit under, say, $150 billion a year.

Dr. Rivlin. There is nothing that won't hurt somebody. I think that it is possible through base-broadening of the income tax—a "laundry list," if you like—to come up with very substantial amounts of new revenue in a way that might make the tax system fairer. But it certainly is a tax increase. There is no way of getting around that.

Senator DANFORTH. And even with the numbers that you have come up with on your very controversial list, that adds up to $71 billion over 3 years, against a 3-year deficit of—what?—close to $600 billion.

Dr. RIVLIN. That's right. It's in the ballpark called for by the budget resolution, which does make very substantial progress against those deficits; so I wouldn't minimize it.

Senator DANFORTH. But even that budget resolution leaves deficits of $130 billion plus.

Dr. RIVLIN. That's right. And the only way that sounds like a small number is to think about what it would be otherwise. For 1986, if you don't do anything, either on the spending side or on the tax side, you will have a deficit of more like $250 billion.

Senator MOYNIHAN. For what year is that?

Dr. RIVLIN. 1986.

Senator MOYNIHAN. Thank you.

The CHAIRMAN. Senator Long.

Senator LONG. Ms. Rivlin, you have made reference to the intangible drilling expense provision. I would like to urge you to compare the information that you have with what the Joint Tax Committee staff has on the same subject, to compare the 5-year writeoff for new equipment, plus the 10-percent investment tax credit, with the intangible drilling expense provision.

I am advised by the outstanding members of the Joint Tax Committee staff that the 5-year writeoff of the equipment, when added to the 10-percent investment tax credit, is just about the same as this first-year expensing. And the first-year expensing of those intangible expenses—that is, the manpower expense and the transportation that goes into drilling a well—is about on a par with what we've done for other industries.

That provision was an advantage to the oil industry at the time when they had their intangibles and the other people did not have the rapid tax writeoff plus the investment tax credit. But I wish you would check it out to see to what extent that changes the picture, because I'm led to believe that the benefits are now about the same.

Dr. RIVLIN. We will certainly look into that. I am not aware that we have any differences with the Joint Tax Committee, but we will certainly look at it.

[Answer to Senator Long's question:]

Senator Russell Long, in answer to your question during the Senate Finance Committee hearing of June 28, the comparison of the treatment of five-year equipment under the accelerated cost recovery system (ACRS) and intangible drilling costs is rather complex.

Before the passage of the Tax Equity and Fiscal Responsibility Act (TEFRA), the treatment of five-year property was more favorable than expensing under most conceivable rates of inflation (the inflation rate is a factor in the effect of cost recovery systems in which deductions are allowed over several years, such as ACRS, but is not a factor under expensing).

TEFRA, however, restricted the cost recovery system in two respects: it repealed the acceleration of recovery allowances scheduled for 1985 and later years, and it required a 50-percent basis adjustment for the investment tax credit. With these restrictions and at moderate rates of inflation, ACRS treatment of five-year equipment is less favorable than expensing.

The ultimate comparison between these two forms of cost recovery will depend on actual inflation. While the benefit of expensing is invariant with inflation, ACRS becomes more generous as inflation slows. Therefore, continued deceleration of inflation could make ACRS again more generous than expensing.

Senator LONG. Well, Mr. Wetzler will have a knowledge of the subject.

Dr. RIVLIN. Yes. I see him right over there.

The CHAIRMAN. The man with the sun tan there.

Senator LONG. Yes. I don't always agree with him, but I think I do this time. [Laughter.]

Senator LONG. Now, with regard to the percentage depletion allowance, as you know at one time that was 27.5 percent for both major companies and for independent producers. It was eliminated for the majors. For the independents, it went down to 18 percent last year; it goes down to 16 percent this year; and next year it goes down to 15 percent. I believe you would agree that there is such a thing as depletion. Whether for tax purposes you compute it using a flat percentage or whether you compute it well by well, there is such a thing as depletion of an oil or gas well.

Dr. RIVLIN. Oh, yes.

Senator LONG. There was a time when the major companies had percentage depletion as well as the independents; now that has been taken from the majors. The independents still have it, but it has been reduced from 27.5 percent, and next year I think it will go down to about 15 percent; so that's a major reduction. So the benefit of percentage depletion is not near as much as you might have computed it to be some years back.

Dr. RIVLIN. Oh, no. That's certainly true. I think the question that remains is really whether treating independents different from majors still has a justification. It is always a disadvantage to be a small company where there are big companies in the industry, but in the oil industry; there are special provisions for that which there are not in other kinds of industries.

Senator LONG. You are certainly aware, and I know you are concerned, about the energy situation in the country. And I would assume you would want us to take into account what our problems are with regard to trying to make headway against our country becoming more energy dependent. I would hope you would agree with me that we ought to try to get all those idle rigs back to work.

Dr. RIVLIN. I didn't catch the last phrase.

Senator LONG. I said I would hope you would agree with me that we should try to get those idle rigs to work. Are you aware that more than 50 percent of our rigs are not working today?

Dr. RIVLIN. Yes. I think the economy may do that for you as it picks up.

Senator LONG. I don't believe it is just the economy that is responsible. In that particular industry, the way I'm led to believe it, the problem they have is a real cash-flow problem. They are having great difficulty finding the capital to put those rigs to work. And I really think that is something we ought to look at.

I am not saying that the problem should be addressed just with taxes. But whatever it takes to do it we ought to find a way, because someone just quoted me some figures the other day showing that 6 years from now, just looking at natural gas, about 40 percent of what we are producing if we are producing our requirements will have to be found between now and then. We will need to have more production activity—a lot more, rather than less—in that area.

In looking at our economy, it is not just a matter of trying to balance the budget; we have other problems beside that that we have to be looking at. I am sure, with the responsibilities that come your way, you are very much aware of that. Aren't you?

Dr. RIVLIN. I am.

Senator LONG. Thank you very much, Ms. Rivlin.

Senator MOYNIHAN. Mr. Chairman, could I just ask a couple of little questions?

The CHAIRMAN. Just let me ask a couple, then I will be happy to.

You know, we are not certain what we are going to be able to do on this committee, but I certainly believe your suggestions, for the most part, have a great deal of merit.

I was just asking the staff—in TEFRA I think there are around 25 separate provisions; maybe you could call it a "laundry list." One of those was tax compliance, which breaks that into about 30 other areas where we tightened up some areas. And so far, we have only lost about a half of one of those—the withholding. We've lost the "with," and we're still holding. [Laughter.]

But we'll still get half the revenue, and as much as 70 percent of that by 1988.

That's why I believe it is essential—and this may not be a view shared by everybody—before we start saying, "Well, we ought to raise marginal rates," or do some other things on ACRS that we just did in 1981, that we ought to go through the code. There are a lot of areas that could be tightened up without any great pain or suffering, at least in my view. Now, I have a little different list than you have, but we didn't want to leave anyone out. But it is not a list that we have any votes for. We have asked the staff to go through this document, which you published in I think February of this year, and work with the Joint Committee and with Treasury.

We have had hearings. Just last week Senator Grassley had hearings on abusive tax shelters, and some of those areas where we have an obvious responsibility. We are now getting into areas where colleges are leasing their campuses and the Navy is leasing ships, and that's about a $14 billion loophole if we don't close it rather quickly, over the next 5 years, I guess. So we have those other additions.

But I certainly appreciate your testimony. I have a number of questions which I would like to submit, because we didn't give you enough notice and there may be some you haven't had a chance to look at. Would that be all right?

Dr. RIVLIN. That would be fine, Mr. Chairman.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Yes, just briefly.

I wanted to understand your statement correctly, Dr. Rivlin. You said that the 1986 budget deficit would be $250 billion. In what circumstances, would this have occurred?

Dr. RIVLIN. That is, if you take the President's defense program and hold all other laws constant. It is what we call a current policy estimate.

Senator MOYNIHAN. Yes.

Dr. RIVLIN. Under those assumptions, you would have the deficit growing from about $200 billion this year to about $250 billion in 1986, to about $300 billion in 1988. It grows very rapidly if you don't take actions on either the spending or the tax side.

Now, the budget resolution would cut from the deficit in 1986 roughly $100 billion—a little more. And part of that on the tax side and part of it on the spending side, to get it down to about $130 billion.

Senator MOYNIHAN. It takes it down to about $130 billion, so the deficit is bein reduced by about $120 billion.

Dr. RIVLIN. Right.

Senator MOYNIHAN. Yes, and that's what we did in the budget resolution?

Dr. RIVLIN. That's what you did in the budget resolution.

Senator MOYNIHAN. Yes.

The other thing I would like to say is: We will have a declining deficit, if we can keep to our resolution and if the assumptions work out in terms of revenues, and so forth.

Dr. RIVLIN. That's right. And the pattern of deficits under the resolution and under the President's budget is rather similar, and also both call for tax increases in 1986. The difference is simply in the composition of the spending cuts and in the timing of the tax increases, because the resolution calls for revenue somewhat sooner than the President's budget.

Senator MOYNIHAN. This is a point I think Senator Danforth will be interested in. He and I are having a friendly disagreement on this subject, or really trying to think about how to address the issue of entitlements.

You spoke of the problem that if social security, medicare, and the defense programs continue their present growth, we aren't ever going to get hold of the Federal budget.

But isn't it the case—and I'm talking here a little bit beyond our normal horizons—the early 1990's—that the trustees have just reported that the social security funds are in surplus now and will meet the expected requirements of the next 75 years, barring some great disaster.

And as an economist, wouldn't it be the case that there is going to be a very rapid buildup of these funds in the 1990's, for about 20 years between 1990 and 2010? Isn't that right?

Dr. RIVLIN. Yes; that seems likely. I didn't mean to imply that you hadn't solved the problem of the Social Security Trust Fund. With the help of the commission of which you were a member, you certainly did. And the prospect now is that the Social Security Trust Fund will be in good shape, and indeed will build up surpluses in the years in which there are not so many older people, when the depression babies retire in the 1990's and around the turn of the century.

Senator MOYNIHAN. My point here is that there ought to be a little cheer to come out of this meeting. An economist would seriously—at least an economist when you and I were first in Washington, and Walter Heller was worrying about fiscal drag—might seriously wonder whether the Social Security Fund should accumulate an additional $30 billion in a given year. It might not be a good economic policy.

And in terms of handling some of the other entitlement programs, we do face the prospects of the generation of surpluses each year in the Social Security Fund.

Senator DANFORTH. Well, could I ask Mrs. Rivlin if she would just then continue her answer? What did you mean to say with respect to the entitlements?

Dr. RIVLIN. You solved the problem of the Social Security Trust Fund, but you didn't solve it by cutting social security spending, except for delaying the COLA 6 months. What you did was to solve it on the other side, by getting more revenues into the trust funds—some from payroll tax, some from other sources. So it is still true that social security is a large growth item in the Federal spending picture altogether.

The other major growth items are medicare and medicaid, especially medicare, where you do have a serious trust fund problem in addition to a general spending problem. The next big trust fund problem to be faced is medicare.

But if you are just looking at Federal spending, those are the growth items—social security, medicare, and to a lesser extent other entitlement programs, but mostly social security and medicare, plus defense and interest.

Senator MOYNIHAN. Well, I think that clarifies the issue. But there is the point in terms of future generations. We have a period of surplus in those trust funds. Is that correct?

Dr. RIVLIN. One might regard that as either good or bad. I think building up a surplus—I think one could argue for a surplus in the Federal budget generally, not just in the trust funds—as a possible way of financing increased investment in that period.

Senator MOYNIHAN. Right. Thank you.

Senator LONG. If I might just interject, I would hope that if we start building up the trust funds that we don't have the same experience we had when there was a surplus last time. Every time we'd take a social security bill out on the floor, we had some Senator with an idea about how we could spend more money—free toupees, free hearing aids, and so forth—so the first thing you knew, the surplus was all gone.

The CHAIRMAN. Thank you very much, Dr. Rivlin. And I will submit about 10 or 15 questions. I would rather do it that way, if it is satisfactory.

Dr. RIVLIN. Fine. We will do our best to answer them.

The CHAIRMAN. Thank you.

## STATEMENT OF DR. RICHARD ROWBERG, MANAGER, ENERGY AND MATERIALS PROGRAM, OFFICE OF TECHNOLOGY ASSESSMENT, ACCOMPANIED BY DR. RICHARD THORESON

Dr. ROWBERG. Thank you, Mr. Chairman.

It is an honor for us to be here today. With me is Dr. Richard Thoreson, from our staff.

My testimony, which I will briefly summarize, is based on a study, Industrial Energy Use, which we are releasing today.

The CHAIRMAN. Is that a copy of the study?

Dr. ROWBERG. Yes.

The CHAIRMAN. You might hold it up so the members will see it. Will that be released today?

Dr. ROWBERG. Yes, the report is being released now and we brought some copies along. We will be sending more over. Thank you.

While we understand that the committee is interested in the whole issue of tax expenditures, we were asked today to present some findings about a particular tax expenditure which we analyzed in some detail in this study. I will first just touch on the findings of that study.

For many years to come, energy need not be a constraint to economic growth in the United States. We project that in the next two decades energy efficiency improvements, changes in product mix, and technological innovation can lead to improved industrial productivity and competitiveness and to increased energy efficiency.

We found that investments in new processes or process technologies would save large amounts of energy and reduce overall costs by improving productivity and product quality. Furthermore, such investments probably will be necessary in order for U.S. industry to remain competitive. Such process shifts will entail capital outlays which in turn will require general economic growth for over many years.

One of the principal goals of this study was to examine various policy alternatives, including tax provisions, which might provide additional incentive to invest in energy-saving technologies.

We found that policies directed specifically at improving energy-efficiency in industry has little influence on investment decisions. Because energy must compete with other factors of production when investment choices are made, policy incentives directed at energy demand alone will be just one of a number of considerations in making these choices.

We examined several policy options in detail, which are summarized in the written testimony. I will highlight one option, the energy investment tax credit.

The energy investment tax credits at a 10-percent level we found had little direct influence on capital allocation decisions in large American firms, and thus had little influence on energy consumption. These credits appear to be too small to exert any change on the returns on investment of most projects or on the cash flow of a company. Energy is just one of many factors determining productivity of a given process, and a targeted incentive such as the energy investment tax credit is diluted to the degree energy efficiency must compete with other factors.

For an energy investment tax credit to be effective for general process equipment, it would have to be substantially increased—probably to numbers greater than 40 percent.

We also touched upon some other measures in our testimony, as I mentioned, concerning policy questions about incentives for energy use.

In conclusion, then, we found that investments in new technology are driven principally by judgments about future profitability. This in turn is affected by increased product demand, productivity, and changes in the product mix.

The policy options we investigated do not affect perceptions of profitability nearly as much as these more macroeconomic considerations. Policies which attempt to discriminate between different types of investments—in other words, on the smaller or micro level—are not effective. Given a healthy economy and reasonable access to capital, however, industry will make investments over the next few decades that will increase productivity and profitability and will have a positive effect on energy efficiency. This improvement can take place without additional Federal incentives. The key is reasonable and stable economic growth, without which even much larger incentives than we have mentioned or considered will be of much value.

Thank you, Mr. Chairman. That concludes my statement. We will be happy to address any questions.

The CHAIRMAN. Thank you very much.

[The prepared statement follows:]

### TESTIMONY OF DR. RICHARD E. ROWBERG, MANAGER, ENERGY AND MATERIALS PROGRAM, OFFICE OF TECHNOLOGY ASSESSMENT

My name is Richard Rowberg, and I am the Manager of the Energy and Materials Program for the Congressional Office of Technology Assessment. With me is Dr. Richard Thoreson, the economist on the OTA Energy and Materials Program staff. The purpose of my testimony is to present the findings of our study, Industrial Energy Use, which is being released today. In particular, I will discuss those findings which concern the effects of various tax policies on decisions by industry to invest in technologies to improve energy efficiency. This study was requested by the Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance, and by the House Committee on Energy and Commerce. The project director was Dr. James Ryan of the OTA Energy and Materials Program staff.

Our objectives in this study were to determine the potential for increased energy efficiency in the United States industrial manufacturing sector, the kinds of technology that could contribute to improved energy productivity, and the principal factors that affect decisions to invest in those technologies. We focused particular attention on the four most energy intensive manufacturing industries in the U.S.—pulp and paper, steel, petrochemicals, and petroleum refining. Our analysis and findings are applicable to the entire U.S. manufacturing industry, however, and it is these findings which I will discuss today.

#### FINDINGS

For many years to come, energy need not be a constraint to economic growth in the United States. We project that in the next two decades energy efficiency improvements, changes in product mix, and technological innovation can lead to improved industrial productivity and competitiveness, and to increased energy efficiency. As a result, the rate of industrial production can grow considerably faster than the rate of energy use needed to fuel that production. More specifically, we project that given a GNP growth rate of 2.7 percent between now and 2000, energy use in manufacturing need not grow more than one percent per year over the same period.

In 1981 the industrial sector used 23 quads of direct fuel, electricity,[1] and fossil fuel feedstock, of which petroleum and natural gas constituted 73 percent. Over the past decade, soaring energy prices have led to significant changes in the absolute amount and mix of energy used in industry. Energy used per unit of product in the industrial sector decreased by almost 20 percent. This improvement was accomplished by housekeeping measures—e.g., plugging leaks and cleaning boilers, equipment retrofits—e.g., insulating steam lines and installing heat exchangers, and new process technologies that produce existing products and new product lines.

---

[1] This is final demand, so that electricity is accounted at 3,412 Btu per KwH.

While industry has made significant strides in lowering costs by reducing energy use, opportunities for further gains in energy efficiency from technical innovation are substantial. Because capital stock has not turned over as quickly in recent years as it did in the 1960's—about 55 to 60 percent of industrial capital stock in this country was older than 25 years in 1980—there is a large backlog of retrofit improvements to be made. Furthermore, high capital costs and the limited capital pool have kept many new process technologies from penetrating product markets. We found that new processes or process technologies would save more energy than would retrofits and housekeeping measures, and would reduce overall costs by improving productivity and product quality. Furthermore, such investments probably will be necessary in order for U.S. industry to remain competitive. However, such process shifts will entail large capital outlays, which in turn, will require general economic growth over many years. Without such growth, there will not be enough capital to finance these productivity improvements. Under these low economic growth conditions, energy use would still grow slowly, but more as a result of lowered economic activity than efficiency improvements.

A product mix shift away from producing energy-intensive products will also continue to contribute to the decline in energy use growth rates. This phenomenon accounted for about 10 percent of the reduction in industrial energy use in 1981 relative to the 1950-73 trend. Product mix shift will occur within specific industries (e.g., a shift from basic chemical production to agricultural/specialty chemical manufacture) as well as from one industry to another (e.g., a shift away from steel to aluminum and plastics in auto manufacture). These shifts are driven by changing demand patterns and international competition, as well as by increasing energy prices.

We also examined how firms decide upon investments in large capital projects, such as those involving new process technology. We found that coporations have a strategic planning process that evaluates and ranks investments according to a variety of factors: product demand, competition, cost of capital, cost of labor, energy and materials, and Government policy. In analyzing energy-related investment behavior, we found no case in which a company accorded energy projects independent status. Although energy costs are high in each of the four industries we examined, costs of labor, materials and capital financing are also high. Thus, energy-related projects are only part of a general strategy to improve profitability and enhance a corporation's competitive position.

Most firms regard energy efficiency as one more item in which to invest and not as a series of projects that are different from other potential investments. This view differs significantly from the view of firms that produce energy or energy-generating equipment where the entire investment is focused on increasing energy production. This difference has important policy implications because incentives aimed at reducing energy demand must usually compete with numerous other factors and are therefore diluted. Energy incentives directed at increasing energy supply suffer no such competition.

## POLICY OPTIONS

One of the principal goals of our study was to determine whether various policy alternatives, including tax provisions, might provide additional incentives to invest in energy saving technologies. Over the years, Congress has passed a number of measures that affect the industrial use of energy. In general, the goals of these measures have been to reduce oil imports, encourage domestic production of fossil fuels, and reduce demand through energy efficiency improvements. We found that legislation directed specifically at improving energy efficiency in industry has little influence on investment decisions. At the highest levels of corporate financial decisionmaking, there is an awareness of Government tax and industrial policies. However, we also found that technical decisions and energy project evaluation tend to be separate from and subservient to corporate financial decisions. Moreover, the decision to borrow depends not only on an individual project's return on investment, but also on such corporate-wide parameters as debt-equity ratio, debt service load and bond rating, and, most importantly, the aforementioned strategic considerations of corporate decisionmaking. Because energy must compete with other factors of production when investment choices are made, policy incentives directed at energy demand alone will be just one of a number of considerations in making these choices. Unless such incentives are substantial, they are unlikely to alter a decision that would have been made in the absence of such incentives.

To assess in detail the effects of a range of incentives on energy use in industry, we selected a set of policy initiatives directed at energy specifically or at corporate investment in general. These options include the following:

Option 1: The accelerated capital recovery system (ACRS) provisions of the 1981 Economic Recovery Tax Act.

Option 2: Addition of a 10-percent corporate income tax credit for investments in energy efficiency-improving equipment.

Option 3: Imposition of a premium fuels tax of $1.00 per million Btu on petroleum fuels and natural gas.

Option 4: Lowered interest rates as a surrogate for capital availability.

In addition, we attempted to determine how these policies would most affect the operation of a corporation.

In order to estimate the effect of these options, we first considered a reference case. This consisted of the current economic and legislative environment, including the 1981 Economic Recovery Tax Act. In the reference case, we project that purchased energy use per dollar of industrial output should decline from a 1980 level of over 50,000 Btu per dollar to under 35,000 Btu per dollar by the end of the 1990's. These projections assume real, energy price increases from 1980 to 2000 ranging from 0.5 percent per year for electricity to 5.6 percent per year for natural gas.

Two points should be made about this projection. First, improvements in energy efficiency are due primarily to investments in new processes and process equipment. These investments and the demand for energy, however, depend greatly on future profitability and, therefore, on economic growth.

Second, projections of the four major sources of industrial energy indicate that natural gas and oil use will remain more or less steady, electricity use will grow at about the same rate as total product growth, and coal use will grow at twice the rate of electricity.

The first option we examined was the effect of the accelerated cost recovery system of the 1981 tax act. By analyzing what would happen if ACRS were removed, we found that it acts as a stimulus for investment, provided the industry is profitable. Under these circumstances, the ACRS would likely accelerate investment and, as a result, there would be a corresponding acceleration of energy efficiency improvements as old equipment is replaced. Consequently, under conditions of improved economic growth, removal of the ACRS would slow the rate of improvement in energy efficiency. Currently, however, factors such as high interest rates, high debt/equity ratios, and low to moderate product demand, are the factors limiting investment decisions.

The most significant shifts in energy use caused by the removal of the ACRS would involve cogeneration and capital-intensive conservation technologies. We project that market penetration of these two categories of equipment would be restricted if depreciation periods reverted to pre-ACRS schedules. A decrease in cogeneration would cause a decline in the self-generation of electricity and waste heat energy recovery by firms. Additional requirements for boiler-generated steam, to make up for the loss of steam for cogeneration, would cause an increase in coal use above that used in the reference case.

Finally, both the ACRS and the energy investment tax credits, discussed next, create situations where third-party financing for tax shelter purposes can be attractive to individual investors who wish to shelter personal income. Such situations can create opportunities for investments that can lead to increased energy efficiency, particularly cogeneration. However, uncertainty about IRS approval for these arrangements has prevented many of them from occurring.

The next option we examined was the energy investment tax credit. Energy investment tax credits (EITC's) at a 10-percent level have little direct influence on capital allocation decisions in large American firms, and thus have little influence on energy conservation. These credits appear to be too small to exert any change on the returns on investment of most projects or on the cash flow of a company. A firm has an overall objective of increasing productivity, and therefore profitability, when it makes an investment in energy-using equipment. Energy is just one of many factors determining productivity of a given process, and a targeted incentive, such as the EITC, is diluted to the degree energy efficiency must complete with other factors of production for investment priorities.

In particular, the shift of two to four percentage points brought about by a 10-percent EITC to a typical 20-percent to 30-percent return on investment on a project is usually not enough to cause a firm to reorder the priorities of its capital allocation plan. We found that some firms claimed only 1 percent of the dollar amount for EITC's compared to that claimed for the general investment tax credit, an indication of the dilution that exists when targeting just one of several factors of production compared to targeting the entire investment. In this connection, tax credits applied to cogeneration are more effective, particularly to third parties whose only objective is the production of cogeneration equipment. Under these conditions, such credits can make the difference between going ahead with the investment or not. For an EITC to be effective for general process equipment, it would have to be substantially increased, probably to above 40 percent.

The third option we considered was a tax on premium fuels. We found that taxes at a rate of $1 per million Btu on natural gas and petroleum fuels—equivalent to about a 25-percent tax, or to $6 per barrel of crude oil—would change the fuel use mix in industry and would cause energy efficiency to improve slightly. In the case of coal, a premium fuels tax would only add to an already large price differential, and therefore the economic incentive to switch to coal would not be significantly increased. For electricity, the tax would be more important in terms of relative prices, but the limited existence of new technologies that efficiently use electricity to replace petroleum or natural gas will constrain conversion to electricity for several years.

Efficiency improvements that result from the premium fuels tax would be a few percent greater than those of the reference case. There are two major reasons for this small increase. First, the total cost of energy, despite a 25-percent increase in the price of premium fuels, will increase considerably less than 25 percent, since gas and oil account for but 60 percent of total industrial fuel use. The net price increase will not greatly accelerate the incentive industry already has to invest in new process technology. Second, a tax just on premium fuels would provide an incentive to switch fuels, which would not necessarily increase overall energy efficiency.

Finally, we analyzed the effects of lowered interest rates as a surrogate for capital availability. Corporations have a strong motivation to invest in new production equipment to maintain or improve their market share. If these corporations also perceive energy prices to be high and believe they will go higher, they have considerable incentive to make sure those investments also increase energy efficiency. Therefore, low interest rates affect energy efficiency to the extent that lower rates may allow a company's cash flow to go further, its debt service to be less burdensome, and its ability to take on more debt to increase. In all cases, low interest rates increase the effective availability of capital and therefore allow more projects to be undertaken. Even with an attractive interest rate, however, investment will be restrained unless there is a perception of profitability and increased capacity utlization through market growth.

We find that the availability of low-cost capital would result in the most significant shifts in total sector energy use from that of the reference case. In this situation capital-intensive technologies, such as cogeneration and heat recovery devices, would be significantly more attractive and would find greater use. Coal use would be greater because of increased penetration in both process and boiler applications.

## CONCLUSION

We found that investments in new technology are driven principally by judgments about future profitability. This, in turn, is affected by increased product demand, productivity, and a change in product mix. Where product demand is expected to grow, as in the pulp and paper and the chemicals industries, investment in expansion will be large and, consequently, energy efficiency improvements will be extensive. Where large changes in production technology are necessary to avoid a substantial loss of market, as in the steel industry, expansion of the industry will not occur, but investment in new technologies will still be large. Finally, where product demand is declining but a product mix shift will occur, as in the petroleum industry, investment will be needed to account for different product slates.

The policy options we investigated do not affect perceptions of profitability nearly as much as do these product questions. The policy options are primarily aimed at accelerating investment, once a decision has been made, or targeting certain aspects of that investment, in this case, energy. Such policies are most effective when directed at capital-intensive items that are primarily concerned with energy, such as cogeneration. Even here, however, the attention to product demand and mix is so dominant that none of the options, with the exception of lower capital cost, changes the decision pattern of manufacturing by a great amount. Given a healthy economy and reasonable access to capital, however, industry will make investments over the next few decades that will increase productivity and profitability and will have a positive effect on energy efficiency. This improvement can take place without additional Federal incentives. The key is reasonable and stable economic growth, without which even much larger incentives than we have considered will not be of much value.

Senator **Bradley**. Mr. Chairman, could I ask a question? Are we going to have hearings any more this week if we are not in session?

The **Chairman**. Well, we have hearings tomorrow morning on so-called tax preferences. Thursday morning we had hoped to be able to mark up revenue sharing, also health care for the unemployed, up to a certain point—not reported out, because we intend to pay for that proposal if we adopt one, and we may wait for the whole revenue package and put it in there.

And finally, there are three ITC nominations that we had hoped to get to.

Senator **Bradley**. So that you intend to meet Thursday, even if the Senate is off?

The **Chairman**. Right.

Now, if we finish by tomorrow noon in the Senate, it may be that, with the agreement of Members, meet tomorrow afternoon, as some may not want to be around Thursday. Is that all right with you?

Senator **Bradley**. Yes.

The **Chairman**. Senator Long, do you have any questions?

Senator **Long**. No questions.

The **Chairman**. Senator Danforth?

Senator **Danforth**. No questions.

The **Chairman**. Well, let me say, first of all, we know that you have done a lot of work, and we appreciate it very much. We are going to be looking at some of the suggestions that you have made.

You indicated in your oral statement as well as in your written statement that the 10-percent energy investment tax credit was generally ineffective in encouraging industrial energy-conservation projects, and you would have to increase that credit to 40 percent before it would have any impact. Do you have any idea of what a 40-percent credit would cost in terms of revenue loss?

Dr. **Rowberg**. Well, we had some estimates of what the 10-percent credit has cost in the last 5 years when it was in effect, and it was on the order of $300 million to $500 million. We expect that on the minimum it would be approximately four times that much over the period, and possibly greater than that.

The **Chairman**. But if it hadn't had any impact, maybe rather than to increase it we ought to forget it.

Dr. **Rowberg**. Well, it seems, from all of the discussions that we had with people in industry, the Energy Investment Tax Credit was almost universally accepted as having no impact on their decisions to invest in energy efficiency. They did like the cashflow when it came in, and they felt it had some merit as an indication of Government's interest in energy conservation; but in terms of rearranging priorities, it didn't do anything.

Dr. **Thoreson**. May I say something? I think many of our respondents—we did a lot of survey work in industry, both large firms and small firms—were very uncomfortable about special tax treatments when it wasn't clear that the tax treatment really made much difference that it was justified by economic conditions. And I think we were quite surprised that there was that much concern on the part of the beneficiaries of this type of special tax expenditure, that they really didn't know if it was justified, and so they generally weren't pushing very hard for it.

The **Chairman.** Well, if it does have an impact I would assume it might shelter some income, and things of that kind. If it doesn't have any impact on production of energy I don't know why we would want to keep it around.

Dr. **Rowberg.** Well, it hasn't, apparently, had any significant impact on those investments. There are other considerations which industry has in mind which are far more dominant.

The **Chairman.** That's what I think we ought to do. I think the fact that you have been talking with people in the business is very helpful. It might be some great idea that a Member of Congress has, but it may not have any merit at all in the real business world. And if there are other areas we should address, maybe a substitution of some kind that would have some real impact—and I think you have some information on that; is that correct?

Dr. **Rowberg.** Well, the major impact in terms of trying to generate savings of energy is to increase general investment, because when you invest in new processes and new process technologies, one of the major byproducts of that is to be a far more efficient process, and that by far will overwhelm any other approach to increasing energy efficiency.

The **Chairman.** Well, thank you very much. We appreciate your testimony, and we will be working with you.

Dr. **Rowberg.** Thank you very much, Mr. Chairman.

The **Chairman.** Our next witness is Willard Birkmeier, mayor of Pekin, Ill.

Mayor, your entire statement will be made a part of the record, and we hope that you might be able to summarize.

## STATEMENT OF HON. WILLARD BIRKMEIER, MAYOR, PEKIN, ILL.

Mayor **Birkmeier.** Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am Willard Birkmeier, mayor of Pekin, Ill. My purpose in appearing before you today is to stress the importance of the tax-exempt industrial development bonds to towns and cities across the United States, as we continue our efforts upward to bringing the economic recovery.

The jobs created by industrial development bonds, with their attendant payroll tax and income tax revenues, are precisely what our State departments of revenue and taxation need, as well as the Federal Treasury, in order to narrow the gap between Government revenues and outlays.

While I recognize that Congress is under much pressure to raise revenues, I would caution that the industrial development bonds underwent significant revenue-raising revisions in the Tax Equity and Fiscal Reponsibility Act of 1982. Most of those provisions relative to the IDB's have been in effect for only 6 months. It seems to me, Mr. Chairman, that is too soon to prejudge the ultimate effect of the recordkeeping, reporting, and public hearing provisions by adding additional restrictions to this program. I am afraid that the additional restrictions such as I have heard discussed and proposed would, if enacted, result in less rather than more revenue at all levels of government.

At this point I would like to digress from the statement that was filed with the committee to tell you some of the things that we do in the Midwest. I am talking about a small community of 35,000 people, and I know most of you are familiar with Pekin, Ill., where our great friend, the great Senator Dirksen, came from, who this building is named after.

We have done quite a bit of industrial bonding for a community of our size, 35,000 people, have done some $150 million worth of it. Basically what we are interested in is industrial development and pollution control. These are the things we have used industrial bonding for in our community. It has enhanced the economy of our community, helped provide jobs—not only from the construction standpoint but on the permanent standpoint of onrunning jobs in industry.

We feel that this Industrial Bonding Act is a very vital situation to our little community of Pekin, Ill., down in the center part of the State.

Some of the people that we have done some bonding for are steel mills—Keystone Steel & Wire. We have done bonding for them. They employ some 300 to 400 of our people over there who have done some pollution-control work for those folks. Commonwealth Edison, which is some 3 miles out of our town; we have done a tremendous amount of industrial bonding for those folks in pollution control; Anerco, a new CO-2 recovery plant right adjacent to an alcohol plant that we have in Pekin, Ill., that we call Pekin Energy, which is a combined effort between Texaco and CPC International; and, Mr. Chairman, we have even enhanced one of your good citizens from Kansas to come to our community some 3 years ago—Midwest Solvents came to our community some 3 years ago with one employee. They now employ 130 people.

These folks are very interested in the Industrial Bonding Act. We help provide minimum cost financing to these folks, and they in turn create jobs and help stabilize our community.

I do not want to go through the complete text filed with the committee, so, to summarize, Mr. Chairman, I would like to stress that it is a worthwhile program for small towns as well as the large communities, based on my experience. We benefit by having the option of attracting large credit-worthy companies to our community.

And finally, I respectfully request that if your committee must raise additional revenues over the next 1 to 3 years, that it not come from further restrictions on this program. Last year's reforms ought to be provided a longer trial period.

Thank you, Mr. Chairman, for the opportunity to appear.

[The prepared statement follows:]

### TESTIMONY OF HON. WILLARD BIRKMEIER, MAYOR OF PEKIN, ILL.

Mr. Chairman and Members of the Committee, I am Willard Birkmeier, Mayor of Pekin, Illinois. My purpose in appearing before you today is to stress the importance of tax-exempt Industrial Development Bonds to towns and cities across the United States, as we continue our efforts toward sustained economic recovery. The jobs created by Industrial Development Bonds, with their attendant payroll tax and income tax revenues, are precisely what our state departments of Revenue and Taxation need, as well as the Federal Treasury, in order to narrow the gap between government revenues and outlays.

While I recognize the Congress is under pressure to raise revenues, I would caution that Industrial Development Bonds underwent significant revenue raising revisions in the Tax Equity and Fiscal Responsibility Act of 1982, most of whose provisions relative to IDB's have been in effect for only 6 months. It seems to me, Mr. Chairman, it is too soon to prejudge the ultimate effectiveness of TEFRA's record keeping, reporting, and public hearing provisions, by adding additional restrictions to this program. I am afraid that additional restrictions such as I have heard discussed and proposed would, if enacted, result in less, rather than more revenue at all levels of government.

This is certainly my overall impression when I consider the adverse impacts of proposals that would deny IDB use to any company with over $20,000,000 in capital expenditures in the three previous years or to any company with $20,000,000 of IDB's outstanding. Our experience in Pekin with companies that use this kind of financing is that we would have far fewer jobs today had this kind of arbitrary limit been in effect in the past. And our experience comes from companies, among others, that are in the forefront of new energy technologies. In fact, rapidly changing technology in the electronics, communications and energy fields require major investments in manufacturing plants over a very short period of time for firms to maintain a lead in the worldwide competition for their products. Twenty million dollar caps would simply distort the market and disqualify top quality users of IDB's.

My view of other proposals, such as those requiring extended depreciation lives, is they would destroy the program, not reform it. Property financed with IDB's, with limited exceptions, already suffers discrimination under ACRS by being limited to straight line depreciation. I see no reason to add further to this disparate treatment.

Mr. Chairman, I am also aware that some in the Congress feel there are abusive, unintended uses for which IDB financing has been provided in the past, and that these practices must be stopped. Far be it from me to urge this or any other Committee's blessing for IDB uses that strike the average citizen, or government official as repugnant. Nevertheless, I must point out that the most obnoxious, notorious uses of IDB's were prohibited last year in TEFRA. Moreover, in TEFRA, Congress sunsetted small-issue IDB's. It seems redundant and smacks of overkill to return 6 months later and enact yet additional restrictions on a program already destined for extinction after December 31, 1986.

Nevertheless, those of us that have had favorable, productive experience with IDB financing in the past, for the general, public benefit of our communities, I might add, see ourselves confronted today with revenue loss charges and unintended use accusations that would lead you to believe that IDB's share a significant responsibility for annual $200 billion deficits, and continue to be used for every reprehensible purpose mankind can conceive. The fact is the Congressional Budget Office's May 1983 report on small issue IDB's stated that their volume increase between 1981 and 1982 was less than one percent, from $12.6 billion to $12.7 billion. Further, CBO sees no significant volume increases in 1983 over 1982. Again, I am suggesting the program is under control and does not require further restrictions.

With these recent developments and future trends in mind, I would like to turn to a discussion of factors that affect interest rate levels, in general. IDB's alleged adverse impact on so-called traditional municipal financings, through crowding out and higher interest rates, is an unfounded charge that must be laid to rest.

The municipal bond market is far too large, Mr. Chairman, and there are too many other known, significant factors that drive interest rates up and down, on both taxable as well as tax-exempt securities, to ascribe so much of the blame to IDB's. Concentrating on the supply of bonds as the sole determining factor of interest rate levels, totally ignores the demand side of the equation, i.e., the demand for tax-exempt bonds. Among the largest traditional purchasers of exempt obligations are banks and non life insurance companies. However, their demand for these securities has decreased sharply since 1979. As their profitability declines, they become net sellers of municipal bonds, rather than purchasers, driving up municipal interest rates as tax-exempt bond supply exceeds demand.

In addition, and regrettably, in recent years, bond rating services have downgraded more municipalities' ratings than they have upgraded. This obviously increases our cost of doing business. From time to time this largely unnoticed bond rating process becomes the center of attention when a project such as Washington Public Power Supply System hits the front pages. A recent Wall Street Journal article noted that the Power System's dilemma, and potential default, would significantly increase borrowing costs not only for other Washington State authorities, but probably for the Pacific Northwest as well. Some analysts even expect the impact on municipal rates to be felt nationwide. However, there is obviously no relationship between IDB volume on the one hand, and the consequences for the bond market of a WPPSS default, on the other.

Federal budget policy and the level of interest rates in general are other external factors that affect interest rates. We have seen a broad decline in interest rates, beginning last fall and continuing through the Spring of this year. This broad decline has been reflected in significantly lower borrowing costs for states and municipalities. During this period, Mr. Chairman, the steady rate decrease has been interrupted on several occasions. On each such occasion, factors that caused jitters in the marketplace were reports of large money supply increases, the Treasury's borrowing needs, the WPPSS problem, and other external events unrelated to tax-exempt bond volume.

To summarize, Mr. Chairman, I wish to stress that this is a worthwhile program for small towns as well as large cities. Based on my experience, we benefit from having the option of attracting large, credit worthy companies to our community. Finally, I respectfully request that if your Committee must raise additional revenue over the next one to three years, that it not come from further restrictions on this program. Last year's reforms ought to be provided a longer trial period.

Thank you, Mr. Chairman, for the opportunity to present my views.

The CHAIRMAN. Thank you very much, Mayor. I think that is probably one of the problems with everybody. They say, "We think you ought to do something, but don't do it to this program because that has an impact on us." And that is going to be difficult.

What is the relative volume of IDB's issued to serve the Pekin area compared to the general obligation bonds issued for roads, schools, and sewers? Do you have any idea?

Mayor BIRKMEIER. I can tell you in my own respect with the city of Pekin. We have no general obligation bonds issued in the city of Pekin at this point.

The CHAIRMAN. You indicate in your written statement that the IDB issuance is under control since IDB issuance increased only by 1 percent in 1982 and future increases are not anticipated by the CBO for 1983. Based on that, would you object to the imposition of volume limitations at current issuance levels to insure that IDB's remain under control? In other words, if we are going to try to control the program, and you indicate there isn't any concern about that, maybe we could devise some way to make certain we keep it under control.

Mayor BIRKMEIER. Well, I think there are probably ways that you can put controls on it to control it more regularly; but we have not had the problem ourselves, is what I'm trying to stress here. We have not got into the pool halls or the skating rinks, or anything like that. We have used it for what it was designed for, and we feel very proud that we have had no losses.

The CHAIRMAN. As I also think your statement indicates, you object to limiting IDB usage to small businesses. If every city and State can issue IDB's to attract large businesses to their area, doesn't that neutralize the advantage any city can obtain? If everybody can do it, what is the advantage?

Mayor BIRKMEIER. Well, I think you have to get down and evaluate what your needs are. I think this is one of the reasons why some communities might have gotten in trouble with it—they did not evaluate the situation.

The CHAIRMAN. But it could also be just another subsidy for a big business who might locate in Pekin, anyway, based on other things, if anybody can offer the same tax subsidy.

You know, we enact pollution control legislation to require changes and to protect the environment, and then we promote

IDB's and other credits to pay the companies for their investment. Again, there is a conflict, with pollution control on the one hand, and then bailing out those who are guilty of it on the other through the Tax Code.

Mayor **Birkmeier.** I think most of it, in our particular area, especially when businesses have gone out and are acquired by a new company, they find that there is a tremendous amount of work to do because possibly the company that went default did not keep up with new technology.

The **Chairman.** Well, I understand it is a very sensitive area.

Mayor **Birkmeier.** It is very sensitive for us.

The **Chairman.** Well, it is sensitive generally. There are high class lobbyists involved. But the efficiencies of IDB's are similar to mortgage subsidy bonds—GAO thinks there is about a 4-to-1 cost-to-benefit ratio for mortgage bonds, so for every $4 we spend there is about $1 in benefit. My point is, if we are going to do that, maybe there is a better way to do it.

We are looking at alternatives on the mortgage revenue bond side. We believe that you could have tax credits, even refundable credits, and save the Government a great deal of money, and design a program that would truly help low-income Americans instead of a lot of people who are benefiting from the program with expensive homes just because it is a subsidy.

You know we looked at the food stamp program, and medicaid, and the WICK program. We cut those programs; but since it is a tax expenditure, we don't believe we have any obligation to take a look at tax expenditures, even though they may have some unintended benefit. That's the difficulty have, and it is not going to be easy to tie a package together that will hold together.

So you understand our problem.

Mayor **Birkmeier.** I understand your problem, Senator. I just thank you for the opportunity to appear before the committee.

The **Chairman.** Well, you have an excellent statement and we appreciate it very much. Having visited your city, I know it is outstanding.

Mayor **Birkmeier.** You are always welcome to come back. [Laughter.]

The **Chairman.** I might do that.

Senator Long, do you have questions?

Senator **Long.** No questions. Thank you very much.

The **Chairman.** Thank you very much. Our next witness is Brian O'Connell, president of Independent Sector, Washington, D.C. Mr. O'Connell will be followed by a panel of three witnesses, followed by another panel of four witnesses which will conclude the hearings for today.

Mr. O'Connell, we hope that you might summarize your statement, and it will be made a part of the record.

## STATEMENT OF BRIAN O'CONNELL, PRESIDENT, INDEPENDENT SECTOR, WASHINGTON, D.C.

Mr. **O'Connell.** I appreciate that. Thank you, Mr. Chairman.

I am the president of an organization that consists of a vast group and a diverse one of the country's foundations, voluntary organizations, and business corporations with national giving programs. The groups are as diverse as the Planned Parenthood Federation of America and Catholic Charities, the American Enterprise Institute and Brookings Institution, the major oil companies and the most ardent of the conservationists. All of these groups have come together because they believe strongly in the importance of the voluntary and philanthropic impulse in our society.

As this committee knows so well, historically tax policy has encouraged the development of voluntary initiatives. Since the Revenue Act of 1917, that encouragement has included the deduction of contributions.

The deduction has provided a very significant incentive for giving; but even more important than the dollars involved it has served to remind all of us that it is the philosophy and the policy of the people and our Government that giving is an act for the public good that is to be fostered.

I won't go into the history of tax exemption and tax deduction; suffice it that through many of the countries from which Americans emigrated, through common law and statute, tax exemption has been a practice and became the common law, and then the legal practice in this country, including the deduction of contributions.

I also certainly don't need to review the history of this pluralism and its impact on our society over the 300 years to now, with the three members of the committee who are present. You have certainly demonstrated, all three of you, your support and awareness of the importance of pluralism participation and what it means to America.

Let me move, therefore, to the effectiveness of the current tax policy, particularly the deduction for contributions. And I am on the bottom of page 4 of our testimony, if you are trying to follow it.

Various studies support the conclusion that the charitable deduction does increase charitable giving and do so considerably in excess of the taxes that would otherwise have been paid. In testimony before this Senate Finance Committee, Martin Feldstein said, "The statistical evidence indicates that the stimulus is substantial: Each 10-percent reduction in the price of giving induces an increase of about 13 percent in the amount of giving." Other studies place that differential as high as 30 percent, and I've seen one even at 42 or 43 percent.

Coming at it from the other side, Rudy Penner of the American Enterprise Institute said, again before this committee, "With regard to the current charitable deduction, I have no doubt that giving would fall drastically if it were eliminated."

Though I realize we are not talking here about the flat rate tax, a recent study that we commissioned I think is relevant in terms of making clear that the tax deduction has worked in terms of inducing greater charitable contributions than have been lost to the Government through revenue foregone.

Charles Clotfelter of Duke University has analyzed for us all of the various flat rate tax proposals now before the Congress, and he indicates, "Even when increased discretionary income is taken into consideration, giving would drop dramatically." He concludes, "The adoption of a flat rate income tax, whether or not it contains a deduction for contributions, is likely to reduce charitable giving significantly." He indicates further that, if the contributions deduction were eliminated altogether, "these effects combine to reduce predicted contributions by almost 20 percent. At upper income levels the reduction is particularly dramatic, averaging over 55 percent."

I would like to end with a point that I realize might be controversial but I think is important to underscore. I suggest very strongly to the committee that charitable contributions should not—should definitely not—in the future be viewed as "tax expenditures."

The availability of the charitable deduction produces more public service and investment than it costs the Government. In addition, these dollars don't remain with or directly benefit the taxpayers involved. You take a deduction only if you have made a contribution to a bona fide public charity; thus, the deduction benefits the community, not the individual.

Taxes transfer income from private use to public use. Private use consists of private consumption plus private savings. These two quantities equal a net income, which is the basis of taxation.

Charitable giving is neither a form of personal consumption nor personal savings. To properly measure net income for tax purposes, the tax law should always allow an income reduction for charitable giving.

There is a less tangible but I think even more compelling reason why a charitable deduction should not be viewed as "tax expenditures." The logical extension of this argument heard more and more is that if these are dollars that the Treasury loses, the Government should have more say about how the money is channeled and spent. Increasingly the term "tax expenditure" is translated as "tax subsidy," and more recently as "indirect grants."

Lest this argument appear abstract, let me report on a conference which I attended in England last December that dealt with the future of private philanthropy in the Western World. I was stunned when the representative of the British Exchequer reported that his government was actively seeking a periodic evaluation of all tax-privileged organizations, to be certain they are fulfilling public needs and priorities as decided by the current government.

I submit that there is nothing more chilling to the independence of our voluntary organizations than to have the Government deciding what is appropriate and what is not appropriate in their behavior. If we want a pluralistic society, then we have got to allow these organizations reasonable independence. To treat charitable contributions in the same way as medical expenses or interest payments is to make the charitable deduction vulnerable to change or elimination, and to contradict the larger public policy consideration, which from the start has been to encourage the vast participation and diversity that are so much a part of America's uniqueness.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. O'Connell.

Senator Long?

Senator LONG. No questions, Mr. Chairman. Thank you.

The CHAIRMAN. Senator Danforth?

Senator DANFORTH. No questions.

The CHAIRMAN. Again, I have some questions, but I am going to submit them in writing.

[Mr. O'Connell's prepared statement follows:]

## TESTIMONY OF BRIAN O'CONNELL, PRESIDENT, INDEPENDENT SECTOR

### TAX EXPENDITURES

*i. Introduction and overview*

My name is Brian O'Connell, president of Independent Sector, a membership organization of 500 voluntary organizations, foundations and business corporations which have banded together to strengthen our national tradition of giving, volunteering and not-for-profit initiative.

Our Voting Members are organizations with national interests and impact in philanthropy, voluntary action and other activities related to the independent pursuit of the educational, scientific, health, welfare, cultural and religious life of the nation. The range of Members includes: National Council of Churches, United Negro College Fund, Shell Companies Foundation, American Association of Museums, Boys Clubs of America, Duke Endowment, American Enterprise Institute, Brookings Institution, Cleveland Foundation, Catholic Charities, Planned Parenthood, Wells Fargo Foundation, Audubon Society, Goodwill Industries, Ford Foundation, American Association of Retired Persons, Opera America, National Urban League, Council for the Advancement and Support of Education, Atlantic Richfield Foundation, American Association of University Women, YM & YWCA's, B'nai B'rith, Native American Rights Fund, American Cancer Society, Hallmark Cards, U.S. Committee for UNICEF, Organization of Chinese Americans, Campfire, National Puerto Rican Coalition and 480 other equally diverse organizations. The common denominator among this diverse mix is their shared determination that the voluntary and philanthropic impulse shall remain a vibrant part of America.

Historically tax policy has encouraged the development of voluntary organizations. Since the Revenue Act of 1917 which created the income tax structure as we know it today, this encouragement has included the deduction of contributions. The deduction has provided a significant incentive for giving but even more importantly has served to remind all of us that it is the philosophy and policy of the people and our government that giving is an act for the public good that is to be fostered. These direct and indirect encouragements have helped to maintain and promote the enormous degree of pluralism and citizen participation that are among the country's most important characteristics.

The desire to do good and to improve the communities in which we live are among the larger and more significant motivations for giving but the tax deduction helps influence the size of many gifts and the regular reminder that charitable gifts are tax deductible makes it clear that giving is encouraged and applauded.

Deductions for charitable gifts should not be considered "tax expenditures" and indeed the application of that concept and category to the charitable deduction threatens the original intent of the government to foster participation and diversity.

*II. History*

Tax exemptions for charities derive from the common law practices of many of the countries, particularly England, from which Americans emmigrated. More specifically it is traced to the "Statute of Charitable Uses" enacted in England in the 16th Century during the reign of Elizabeth I. Tax exemptions were a natural part of the common law of the American colonies and were intended to maintain the essential separation of Church and State and to encourage dispersion of power and organized neighborliness.

The deduction of gifts to charitable organizations has been an integral part of the income tax law since the Revenue Act of 1917. The intent to encourage contributions to the causes of one choice was reaffirmed and substantially extended in the Economic Recovery Tax Act of 1981 when the right to deduct charitable gifts was again provided to all tax payers, including even those who use the "short form."

The same Act increased from 5 percent to 10 percent the allowable deduction for charitable contributions by business corporations and it reduced to a flat 5 percent the annual payout requirement for private foundations. In other ways, legislation and court decisions have affirmed the government's willingness and desire to foster charitable activities of foundations and businesses.

### *III. America's pluralism*

There are approximately 350,000 organizations in the United States that have been officially designated as 501(c)(3) organizations which means that they are exempt from paying income taxes and that contributions to them are tax deductible. In addition there are at least a like number of churches, which have the same tax status but which are not required to apply for tax exempt classification. Thus, there are at least 700,000 public charities. Eighty percent of Americans are contributors providing $60 billion a year to the causes of our choice. Forty-seven percent of us are volunteers giving 8.4 billion hours annually that are worth at least $65 billion to the recipient organizations. These dollars and hours sustain the churches, hospitals, museums, social service agencies, clinics, historical societies, job training centers, bird watching societies, nonprofit theatres, civil rights groups, and the thousands of other organizations that are the fabric of our communities and country. Some are conservative, some are liberal and many are in opposition to one another on issues like family planning, free trade or disarmament. They contribute to an enlightened electorate and represent alternatives by which citizens deal with their problems and aspirations. They serve the public interest by: Providing essential services to meet fundamental human needs; serving the basic principles of democracy by encouraging pluralism and social responsibility; providing opportunities for individuals to effect the quality of life in their communities; and serving as vehicles for innovation, experimentation and social change.

### *IV. The effectiveness of current tax policy*

The government has consistently encouraged nonprofit organizations because: Charitable contributions are discretionary expenditures in support of the social good; voluntary gifts in support of public activities relieve government of expenditure requirements; and the encouragement of voluntary organizations increases the degree of volunteered time which in turn expands services and creates a more sensitive and enlightened citizenry.

From the start, it has been the intent of the American people and our government to disperse power and to decentralize services. Thus, even tax policies encourage voluntary associations.

Various studies support the conclusion that the charitable deduction does increase charitable giving and does so considerably in excess of the taxes that would otherwise have been paid. In testimony before the Senate Finance Committee in January, 1980, Dr. Martin Feldstein, then head of the National Bureau of Economic Research and now Chairman of the Council of Economic Advisors, stated: "The statistical evidence indicates that the stimulus is substantial: Each 10 percent reduction in the price of giving induces an increase of about 13 percent in the amount of giving."

Other studies place the differential as high as 30 percent.

Looking at it from the reverse side, Rudolph G. Penner, an economist with the American Enterprise Institute stated: "With regard to the current charitable deduction, I have no doubt that giving would fall drastically if it were eliminated."

Though all causes would be impacted by removal or reduction of the deduction, those that are the regular recipients of gifts from persons with incomes above $30,000 would be hurt the most, including and especially higher education and arts and other cultural organizations.

Independent Sector recent commissioned Professor Charles T. Clotfelter of Duke University to analyze the various flat rate tax proposals now before Congress. His report indicates that, "even when increased discretionary income is taken into consideration, giving would drop dramatically." He concludes, "The adoption of a flat-rate income tax, whether or not it contains a deduction for contributions, is likely to reduce charitable giving significantly." He indicates that if the contributions deduction were eliminated altogether, "These effects combine to reduce predicted contributions by almost 20 percent. At upper income levels, the reduction is particularly dramatic, averaging over 55 percent—." At higher income levels, he says, "the negative effect of the elimination of the deduction completely swamps the positive effect on contributions of an increase in after-tax income caused by the approximate halving of tax liability."

Consideration of elimination or reduction of the charitable contributions deduction comes at a time when voluntary organizations are being asked to greatly expand services to help deal with government cutbacks and the increased need for services. They also occur at a time when Americans of all political and philosophical persuasion are realizing some practical limitations of big government and are looking to local voluntary organizations to expand their attention to local needs.

*V. Charitable contributions should not be viewed as "tax expenditures"*

The availability of the charitable deduction produces more public service and investment than it costs the government in revenue foregone. In addition, these dollars don't remain with or directly benefit the taxpayers involved. One can take the deduction only if one has contributed to bona fide public charities. Thus, the deduction benefits the community, not the individual.

Taxes transfer income from private use to public use. Private use consists of private consumption plus private savings. These two quantities equal net income which is the basis for taxation. Charitable giving is neither a form of personal consumption nor personal savings. To properly measure net income for tax purposes, the law should always allow an income reduction for charitable giving.

There is a less tangible but I think even more compelling reason why charitable contributions should not be viewed as "tax expenditures." The logical extension of this argument, heard more and more, is that if these are dollars that the Treasury loses, the government should have more to say about how the money is channeled and spent. Increasingly the term "tax expenditure" is translated as "tax subsidy" and more recently as "indirect grants."

Lest this argument appear abstract, let me report on a conference which I attended in England last December that dealt with the future of private philanthropy in the Western world. I was stunned when the representative of the British Exchequer reported that the government was actively seeking a periodic analysis of all tax-privileged organizations to be certain they are fulfilling public needs and priorities as defined by the government. He said their right to do so was based on the combination of tax exemptions and tax expenditures. It was even more chilling to realize that it was primarily the U.S. delegation that reacted with horror to a proposal that would so threaten the essential independence of voluntary organizations.

If we want a pluralistic society—of experimentation, alternatives, criticism and reform—then we cannot overly define what these citizen organizations can and should do. That would bring prejudice to the very arena where it least belongs. At the extreme, there is no greater danger to the preservation of liberty than allowing those in power to have control over their reformers.

To treat charitable contributions and deductions in the same way as medical expenses or interest payments is to make the charitable deduction vulnerable to change or elimination and to contradict the larger public policy consideration which from the start has been to encourage the vast participation and diversity that are so much a part of America's uniqueness.

The CHAIRMAN. I think our responsibility is to make certain we aren't just creating a windfall for taxpayers who are going to give in any event. I mean, we may lose more revenue than is donated, if we are not careful. But it is an area that deserves careful attention, one that we are certainly going to focus and one that we are pleased to have your testimony on.

Mr. O'CONNELL. If I might suggest, I take polite exception to the thought that one could use it as a "windfall." You can only deduct it if you in fact have made bona fide contributions.

The CHAIRMAN. Well, I think that is essentially accurate, but I think it is fairly flexible. I know of a few examples myself.

We appreciate it very much, and I will submit some questions in writing.

Mr. O'CONNELL. I would appreciate it.

The CHAIRMAN. We now have a panel of witnesses. Two of the three are present: Robin Swift, on behalf of the forest industry's Committee on Timber Valuation and Taxation, and Richard E. Morgan, research director, Environmental Action Foundation, on behalf of Environmental Action.

I have to leave at this point, so let me suggest that they will be followed by a panel of Dr. Carlson, David Smith, Wallace Woodbury, and Mr. Aronsohn, and then that will conclude today's hearing. Senator Danforth has indicated that he would be willing to complete the hearing. I need to attend the graveside service of former Congressman Miller.

Mr. Swift?

## STATEMENT OF G. ROBIN SWIFT, JR., ON BEHALF OF THE FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION, WASHINGTON, D.C.

Mr. SWIFT. Thank you, Mr. Chairman.

My name is Robin Swift. I am president of Swift Lumber Co., a small family-owned, lumber-manufacturing concern in south Alabama. I am accompanied by Mr. Bill Condrell, partner in Steptoe & Johnson, and Mr. Bob Ladig, vice president of Scott Paper Co.

I am here as chairman of the Forest Industries Committee on Timber Valuation and Taxation. This committee speaks on behalf of 5 million timberland owners throughout the country. We are appearing today in support of timber capital gains treatment.

The capital gains treatment of timber has stood the test of time for almost 40 years now, including many reviews by Congress. And as Congress originally intended, it provides two basic ingredients: One is equity, and the other is incentives that are in the national interest.

In the area of equity, with the creation of timber capital gains, investments in timber achieved parity, as far as taxes are concerned, with other long-term, high-risk investments. Within our industry, we gained equity in that those who liquidated and had always enjoyed capital gains were put on a par with those who managed their timber for long-term production.

In the area of incentives, without this treatment, Mr. Chairman, private landowners will be reluctant to enter into the production of timber.

I have been in this field now since 1950, beginning 6 years after the establishment of the capital gains treatment, and I have seen it happen. And I know that it has been well documented that it has had a great effect on the nationwide growth of timber and the planting of trees. Without this incentive, in my opinion, the investment in trees will simply not be made, and the resource will not be grown.

Mr. Chairman, the timber industry is just climbing out of a 3-year depression. One of those years was 1981, a year which has been singled out in the Pease-Dorgan study of taxes paid by five major forest products companies. If you will refer to appendix A attached to my written testimony, you will find that we have expanded that 1-year study into a 4-year study, covering the years 1978, 1979, 1980, and 1981. We did this in order to give the concept a little broader prospect and in order to meet the charges head on.

You will note that the years 1978 and 1979 were more typical years in our industry, and that these five major companies had effective tax rates that were very near the norm for industry as a whole in the United States.

In the years 1980 and 1981, which were depression years, we had lower profits, but we had high investments within those five companies that were already committed. As a result, the investment tax credit and accelerated depreciation caused rather large tax deductions. You will note on lines 3 and 4, the 1980 and 1981 lines, that those reductions in effective tax rates in each instance—both investment tax credits and depreciation—were higher than the adjustment for capital gains. In fact, in 1981, if there had been no adjustment for capital gains, it would still have been a negative figure because of the investment tax credit and excess depreciation.

Finally, Mr. Chairman, I would point out that capital gains treatment in and of itself cannot result in negative effective tax rates, because the rate is a positive 28 percent.

That concludes my testimony, Mr. Chairman. I will be glad to answer any questions.

[The prepared statement of G. Robin Swift, Jr., follows:]

# Prepared Statement of G. Robin Swift, Jr., President, Swift Timber, Inc., on Behalf of the Forest Industries Committee on Timber Valuation and Taxation

## I. INTRODUCTION

Mr. Chairman and members of the Committee, I appreciate very much this opportunity to testify on behalf of the Forest Industries Committee on Timber Valuation and Taxation. Our Committee speaks on behalf of more than five million forestland owners of all sizes from all regions of the country.

The principal public policy objective of our Committee is the attainment and preservation of equitable federal tax provisions that reflect the long-term nature of forest investments and the unique risks involved. We are appearing today in support of timber capital gains treatment, one of the dozens of tax expenditures that this Committee is reviewing at these hearings.

Timber capital gains treatment was added to the Code by Congress in 1944 because the tax treatment of timber owners prior to that time was inequitable and prejudicial to our Nation's timber resources. Timber capital gains treatment has since been reexamined by Congress in 1954, twice in the 1960's, and three times in the 1970's. Each such reexamination reaffirmed the continued need for its retention.

We welcome this opportunity to appear again before this Committee to review how timber capital gains treatment promotes equity and assists our Nation in meeting its future wood and fiber requirements.

## II. TIMBER CAPITAL GAINS TREATMENT -- SOUND, RESPONSIVE AND NECESSARY

### A. Equity Among Timber Owners

Under the specific timber provisions of Section 631, an owner who cuts his timber or disposes of it under a contract with a retained economic interest is eligible for capital gains treatment. It is important to recognize that this section does not apply to a timber owner who makes an outright sale of standing timber. Rather, such an owner is disposing of a capital asset, and accordingly is generally taxed the same as the owner of any capital asset.[1/]

---

[1/] With the exceptions noted in the second paragraph, an outright sale of standing timber gives rise to capital gains treatment, since standing timber is a capital asset under I.R.C. § 1221, unless the standing timber is deemed to be used in a trade or business. I.R.C. § 1221(2). In the latter case, however, an outright sale of standing timber obtains capital gains treatment under I.R.C. § 1231(b)(1), since it is real property used in a trade or business. (Both fee interests in standing timber and long-term harvesting rights are generally treated as real property under state law. See, e.g., 73 C.J.S. Property, § 7c, p. 160, § 8, p. 174-75; 98 C.J.S. Woods & Forests, § 2, pp. 688-89; 54 C.J.S. Logs and Logging, § 11, pp. 686-88). Note that capital gains treatment under I.R.C. § 1231(b)(1) is available independently from I.R.C. § 1231(b)(2) (relating to Section 631 transactions), since an outright sale of such timber is not covered by Section 631.

Regardless of whether I.R.C. § 1221 or I.R.C. § 1231 applies, capital gains treatment will be available only if the standing timber was held for one year (I.R.C. §§ 1222(3), 1231(b)(1)), and if it was not held primarily for sale to customers in the ordinary course of a trade or business (I.R.C. §§ 1221(1), 1231(b)(1)(B)).

Prior to the adoption of the specific provisions for timber capital gains in 1944, if a timber owner cut his timber for sale, he was taxed at ordinary income tax rates on whatever total gain resulted. Thus, such an owner was taxed at a higher rate than if he sold the timber outright and let the purchaser come on his lands to do the cutting.

Similarly, under prior law, if a timber owner cut his timber for use in his business, he was taxed at ordinary income tax rates on both the appreciation inherent in the timber before it was cut and the value added after cutting. For example, a sawmill operator who owned standing timber and cut it for use in his sawmill had to pay the higher ordinary tax rates on both the appreciation inherent in the timber before it was cut and the value added after cutting. Thus, as a practical matter, the sawmill operator who owned standing timber would have been better off selling his timber outright, and then buying logs from another landowner as needed in his mill. In this way, he would obtain capital gains treatment for the appreciation inherent in his standing timber, and would be subject to ordinary income tax on profit attributable to the logging and conversion.

Equity was achieved in 1944 by the enactment of Section 117(k), the predecessor to Section 631(a) and (b). As a result, an owner who cuts his timber or disposes of it under a contract with a retained economic interest obtains in general the same treatment as an owner who sells his timber outright. This is the proper tax result since the net economic result of each of these transactions is the same.

The specific timber provisions merely provide a means to distinguish the appreciation in timber from the value added to the resulting logs or timber products. The appreciation is taxed at capital gains rates, the same as other capital assets; the latter is taxed at ordinary income rates, the same as other converting or processing profits. In contrast to prior law, which resulted in an incentive for outright liquidations, the present law results in effective tax policy by removing a penalty against holding and managing timber for long-term growth. Thus, the specific timber provisions implement a uniform and consistent tax policy by providing all timber owners with the same tax treatment, regardless of which of the various types of timber transactions are employed.

This treatment is altogether consistent with the underlying provisions of the Code. Real property (including timber) held for investment has always been defined as a capital asset. Since 1942, all real property (including timber) "used in the trade or business," owned for the requisite period and not held primarily for sale or in the ordinary course of business has been uniformly subject to capital gains treatment under what is now Section 1231.

The specific timber provisions of Section 631 merely establish equity among all timber owners consistent with existing law. They do this by (1) eliminating the previous discrimination against timber sold under contracts with retained economic interests; and (2) providing those who cut timber for "use in a trade or busines" or for sale with a simple way to measure the capital gains inherent in the timber.

### B. Commitments Made in Reliance on Long-Standing Tax Policy

Many businesses and individuals planted and managed their timber stands relying on the availability of a moderate timber capital gains tax rate when the timber stand matured. This tax rate is a critical component in the rate of return calculations customarily made prior to undertaking any substantial investment.

A midstream change in the tax rules would be grossly unfair to those timber owners who have reasonably based their investment decisions on continuation of a tax policy which has been the existing law for almost 40 years.

And to change the law only for prospective investments would create, apart from administrative difficulties, significant inequities and competitive distortions between the "haves" and the "have nots."

Moreover, the repeal of timber capital gains would have deleterious effects on those many communities dependent upon harvesting and processing our nation's timber resource. Those communities rely heavily on the timber industry for economic and fiscal suport, counting on timber as an important source of jobs and tax revenues.

### C. Unique Nature of Timber Investments

Absent capital gains treatment, the economics of growing timber continue to be unattractive. This results first from the inherent substantial front-end investments in land and planting costs, the carrying costs, and the 30- to 100-year growing cycle for timber. The effect of these factors is to tie up investments for extended periods without any current returns. Second, the return that is generated is substantially lower than the return available from other types of investments. Third, substantial risks, such as fire, insects and disease, and windstorms, exist with respect to timber. The long-term growing cycle of timber results in an increased exposure to these risks far beyond that of other types of investments. Without capital gains treatment for timber, there would be an unfair bias in favor of other more liquid, less risky investments that receive capital gains treatment.

### D. Dramatic Response in Timber Management and Reforestation

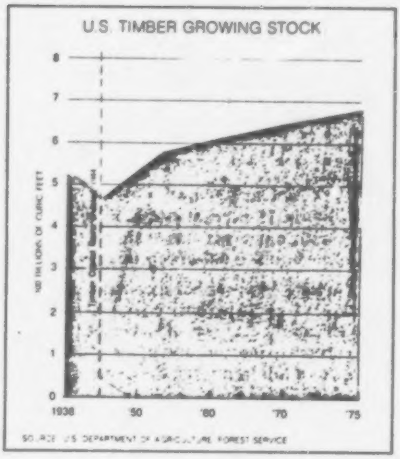
There is probably a no more dramatic example of the direct relationship between tax policy and producer response than that evident in the history of the timber economy throughout the twentieth century.

Before 1944, the year timber capital gains treatment was enacted, the timber resource was in a state of alarming decline: The United States had seven billion cubic feet less timber at the end of every year than at the start. The enactment of the specific timber capital gains rules dramatically reversed that trend.

Since 1944 over 30 million acres of private lands have been planted, compared to only 3 million acres in all previous years. Scientific forest management is now practiced in all regions of the country.

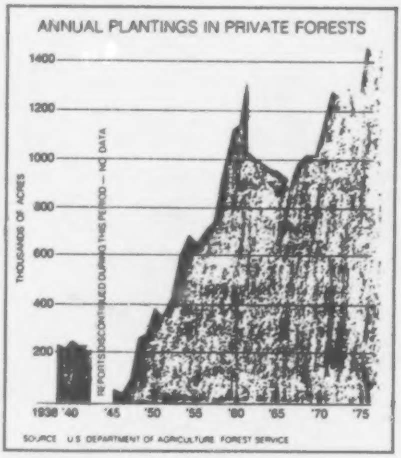
Tables I and II show the impact in terms of timber growing stock annual plantings in private forests:

Table I



SOURCE: U.S. DEPARTMENT OF AGRICULTURE, FOREST SERVICE

Table II



SOURCE: U.S. DEPARTMENT OF AGRICULTURE, FOREST SERVICE

## E. Substantial New Investment Required to Meet Nation's Future Timber Needs

To satisfy our Nation's future timber needs, a 1980 industry study (conducted in concert with federal and state agencies) determined that approximately $8 to $10 billion in new investments will be necessary over the next decade.[2] Were timber capital gains treatment repealed, such investment would be extremely unattractive.

The Forest Service estimates that domestic demand for paper and wood products may double by the year 2030 with the demand for paper and wood products climbing from 13.4 billion cubic feet in 1976 to 28.3 billion cubic feet in 2030.[3] Table III summarizes the projected supply/demand situation:

Table III

Summary of U.S. Supply
and Demand for Timber in 1976 and 2030 4/

| Category | Billion Cubic Feet<br>1976 | <br>2030 |
|---|---|---|
| Total U.S. demand | 13.4 | 28.3 |
| Exports | 1.8 | 1.3 |
| Imports | 2.8 | 4.5 |
| Demand on U.S. forests | 12.4 | 25.1 |
| Supply from U.S. forests | 12.4 | 21.2 |
| Supply/demand balance | 0.0 | -3.9 |

Source: U.S. Forest Service

---

2/ Forest Industries Council, Forest Productivity Reports (1980).

3/ In part because of the hazards of making estimates of what is likely to occur fifty years hence, the Forest Service has assumed three alternative economic and demographic scenarios for its estimates. Thus, based on these scenerios, the Forest Service has developed three alternative possible future demand levels -- low-level demand, medium-level demand, and high-level demand. The data presented in this testimony depicts the results that will ensue if medium-level demand were to occur.

4/ Assumes medium-level demand (*see* note 3, *supra*) and price rises, net of inflation, similar to those experienced from late 1950s to mid-1970s.

The continuation of timber capital gains treatment is necessary if this shortfall is to be met.

To meet the nation's future forest product needs, timber must continue to be planted today. Unlike mistakes in other areas of tax policy, which can be corrected without long-term effects, an adverse change in timber tax policy will directly result in lost tree growth -- a loss which is irreversible even with modern forestry technology. Intensification of future planting efforts will simply not replace the lost timber volume in the time frame in which it will be needed

### F. U.S. Forest Products Compete In World Markets

U.S. forest products companies have proven to be exceptional competitors in international trade and there is excellent potential for further improving our position in world markets. However, virtually every industrial country in the free world has recognized the unique risks attendant to timber growing, and has in place special tax incentives to encourage investment in future timber stands. It is irrational for U.S. producers to develop these market opportunities, only to discover that they are at a competitive disadvantage because of parent country tax disincentives.

### G. Encouraging the Availability of Lumber and Wood Products Promotes Conservation of the Environment

During the extended period of time from planting of timber to maturity, timber growing represents a major commitment to the conservation, recreation and scenic enjoyment needs of the general public. In comparison to many of the products with which wood competes, forest products are produced with relative energy efficiency and structural wood products manufacturing has made great strides in reducing fossil fuel dependency, substituting wood residuals (in addition to those used as raw materials for pulp and paper manufacturing) as fuel. Pulp and paper manufacturing now supply approximately 50 percent of its own BTU requirements, using process residues for fuel, a significant increase in energy self-sufficiency since the early 1970s. The industry's positive conservation, energy, and environmental accomplishments are a recognized matter of record.

## III. MISPERCEPTIONS ABOUT TIMBER

### A. Overstated Joint Committee Tax Expenditure Estimates

The Joint Committee on Taxation (JCT) estimates that the tax expenditures associated with timber capital gains are $515 million in FY 1984, $580 million in FY 1985, $675 million in FY 1986, $775 million in FY 1987, and $825 million in FY 1988.[5] These estimates, however, appear to substantially overstate the revenues that would be generated if timber capital gains treatment were repealed.

Data from a forest industries survey indicates that the tax benefit derived from timber capital gains treatment is significantly below the JCT projections. We estimate on the basis of this survey data that the industrial sector benefited from timber capital gains treatment by approximately $220 million in FY 1980, $175 million in FY 1981, and $85 million in FY 1982. Using the Treasury Department's estimate that 30 percent of all timber capital gains are attributable to individuals, we extrapolated the total cost of providing timber capital gains treatment: $315 million in FY 1980, $250 million in FY 1981, and $120 million in FY 1982.

In light of this decidedly downward trend, we do not fully understand the assumptions underlying estimates that would indicate a reversal of that trend to the extent that the tax expenditures associated with timber capital gains treatment are projected to be up to three and one-half times the average benefit realized during the past

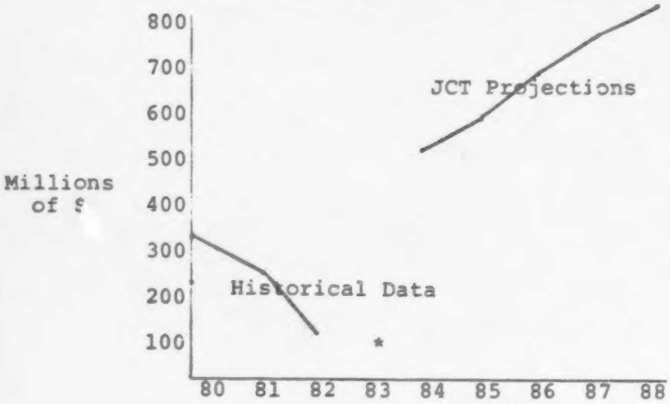
---

5/ Joint Committee on Taxation, Estimates of Federal Tax Expenditures (March 7, 1983).

three years. Juxtaposing the results from the last three years against the projections results in the following comparison:

Table IV

REVENUE LOSS ESTIMATED TO RESULT FROM THE REPEAL OF TIMBER CAPITAL GAINS: COMPARISON OF HISTORICAL DATA WITH JCT PROJECTIONS



---

* Not available

While the timber industry is currently recovering from the recession, the JCT projections can hardly be credible since neither the extent nor the duration of the recovery is known.

The JCT's estimates appear to be based on historical trends that ignore the experience of recent years. Also, the tax expenditure estimates do not take into account the interrelationship between capital gains and other provisions, such as minimum taxes. Thus, the tax expenditure data is an inappropriate basis for estimating the revenues that would be gained from the repeal of timber capital gains treatment and are a poor predictor of the revenue increase that might be expected were timber capital gains repealed.

### B. Analysis of Pease-Dorgan Survey

While a survey publicized by Congressmen Pease and Dorgan indicated that five forest products companies had a negative effective tax rate for 1981, the survey results are misleading. One unfamiliar with the industry might assume that timber capital gains treatment was the major contributor to the low rate, but this is simply not so. Almost half of the low effective rate was, in fact, caused by accelerated depreciation and investment tax credit (many of the companies being in excess credit situations) resulting from significant new investment in plant and equipment even during these difficult economic times. While the companies still realized timber capital gains benefits, the relationship of such benefits to the negative effective tax rate is summarized as follows:

| | |
|---|---|
| Nominal Tax Rate | 46.0% |
| Accelerated Depreciation and Investment Credit | (27.3) |
| Other Adjustments (non-timber) | (21.0) |
| Capital Gains | (6.7) |
| Effective Tax Rate | (9.0%) |

The year 1981, with the severe recessionary impact, was not a representative year for the timber industry. In more typical years, the timber industry's effective tax rate is not dissimilar to the effective tax rates of other industries. A more complete discussion of an analysis of the Pease-Dorgan survey is contained in Appendix A.

### C. Marginal Rate of Return

Even with capital gains treatment, the return from investment in timber is marginal. Federal Trade Commission reports indicate the return on equity from paper and allied products for the period 1960-1979 to be 11.1 percent, compared with a return of 12.5 percent from all durable and nondurable goods produced. Although separate numbers for timber and wood products were not maintained by the Federal Trade Commission later than 1973, the comparable figures for 1960-1973 show a similar pattern.

## IV. CONCLUSION

Timber capital gains treatment has for almost 40 years provided a powerful incentive for proper management of our nation's timber resources. By providing identical tax treatment to comparable timber dispositions, the specific timber capital gains provisions promote equity among all timber owners.

Without a tax policy that encourages the proper management of our timber resources, the timber needs of future generations will not be met as the required investment will not be made. Timber, which is subject to unique risks, has historically had a rate of return below that of other investments. The specific timber capital gains rules merely enable timber to compete for investment dollars with other, more liquid investment opportunities.

Mr. Chairman, I believe that the record amply demonstrates the continued need for timber capital gains treatment. We would be pleased to answer any questions that you may have.

## APPENDIX A

## ANALYSIS OF PEASE-DORGAN SURVEY RESULTS

The Pease-Dorgan survey, published in the Congressional Record last December, indicated that five paper and wood products companies had a 1981 effecive tax rate which was negative for both worldwide income and U.S. income. An analysis of these five companies' effective tax rates disclosed that while the five companies did receive significant capital gains benefits, timber capital gains treatment simply was not the major contributor to the low rate.

The analysis done using the approach employed by the Joint Committee on Taxation revealed that the most significant cause of the low effective tax rate was the five companies' susbstantial new investment in plant and equipment. Excess depreciation reduced the companies' effective tax rate by 15.7 percentage points with the investment tax credit further reducing the rate another 11.6 percentage points, 27.3 percentage points in the aggregate.

From this analysis, it is clear that the capital gains tax contributed in only a modest way to the 1981 negative effective tax rate of the five companies as it reduced their taxes by 6.7 percentage points. In this regard, it should be emphasized that the timber capital gains rate cannot result in a negative effective tax rate since the rate on capital gains is 28 percent.

A single year's data, however, indicates little. As Congressman Pease stated when introducing the Pease-Dorgan survey into the Congressional Record,

> While raw numbers are of little interest by themselves, tracking their year-to-year changes in future tax studies will allow us to see growth or decline of industries and their tax contributions to the operation of our country.

Thus, we computed the effective tax rates of these five companies over the period 1978 to 1981, and analyzed their contributing components. This analysis is presented on page 4.

The analysis also indicates that 1981 was not a typical year for the five companies. Rather, the negative tax rate in 1981 was the result of significantly lower earnings because of the recession, at a time when large capital projects were coming on stream. This combination of events -- relatively low earnings and high depreciation deductions and investment tax credits--produced net operating losses and investment tax credit carrybacks resulting in refunds of taxes paid in prior years, i.e., negative taxes in 1981. For the remaining years, the five companies had a positive effective tax rate although the rate for 1980 was low, showing marked similarity to 1981. For the more representative years 1978 and 1979-- prior to the recession--the five companies' average effective tax rate was 23.6 percent.

In summary, the analysis indicates that timber capital gains had little effect on the 1981 effective tax rate; that the negative effective tax rate was peculiar to the circumstances of 1981; and that the effective tax rate of the five forest products companies in a normal year approximates the 1981 effective tax rate of the average of all industries shown in the Pease-Dorgan survey, 25.1 percent.

ANALYSIS OF EFFECTIVE TAX RATES FOR FIVE PAPER AND WOOD PRODUCTS COMPANIES(a)/
1978 to 1981

|  | (1) | (2) | (3) | (4) | (5) | (6) | (7) |
|---|---|---|---|---|---|---|---|
|  |  | Other Adjustments to Nominal Rate |  |  |  |  |  |
| Tax Year | Nominal Tax Rate | ITC | Tax Depreciation Over Book Depreciation | Other Adjustments Net (b)/ | Total Col. 2+3+4 | Adjustments For Capital Gains | Pease-Dorgan Effective Tax Rate (c)/ (Col. 1-5-6) |
| 1978 | 48.0 | (4.4) | (5.4) | (2.7) | (12.5) | (10.0) | 25.5 |
| 1979 | 46.0 | (5.4) | (3.7) | (3.6) | (12.7) | (11.6) | 21.7 |
| 1980 | 46.0 | (10.4) | (8.2) | (16.6) | (35.2) | (7.0) | 3.8 |
| 1981 | 46.0 | (11.6) | (15.7) | (21.0) | (48.3) | (6.7) | (9.0) |

1981 effective tax rate for the average of the 22 industry groupings in the Pease-Dorgan Survey...25.1

---

(a)/ Computed by a methodology comparable to that used by the Joint Committee on Taxation in "Taxation of Banks and Thrift Institutions" (March 9, 1983). The five companies are those selected by the Pease-Dorgan survey.

(b)/ Including Pease-Dorgan adjustment; excluding capital gains.

(c)/ Computed in accordance with Pease-Dorgan study, Congressional Record (Dec. 20, 1982) at H. 10545.

Senator DANFORTH. Senator Long?

Senator LONG. No questions.

Senator DANFORTH. Why should somebody who is a grain farmer be taxed at ordinary income, while somebody whose crop is trees be taxed at capital gains rates?

Mr. SWIFT. Senator, a grain farmer plants and harvests his crop all in the same year, usually within a 3- or 4-month span; whereas, a timber grower plants his trees and does not get any revenue, even in the South where I live and the cycle is fairly short, for 20 or 25 years, and the real crop harvest is more like 35 or 40 years. It is a long-term investment as opposed to a short-term investment.

Senator DANFORTH. You don't think that people would be raising timber but for this tax treatment?

Mr. SWIFT. No, sir, I do not. I think the national statistics will bear it out. My own experience, however, is that certainly that is not true.

Our company subsists almost entirely from timber from private landownerships that are not our own—we have no land base. And I think if we did not have the capital gains treatment of timber in effect, our company would be in serious jeopardy from a supply standpoint.

Senator DANFORTH. Are most of the people really in the tree-farming business, or do they just cut trees that happen to be growing on their property?

Mr. SWIFT. Senator, that's all over the ballpark. You will find some who just happen to have trees, but there are more and more who are very seriously in the tree farm business.

Senator DANFORTH. Why would somebody who is just cutting trees on his property get capital gains? Why would that be any incentive? They would have to cut them down anyway, wouldn't they?

Mr. SWIFT. No, sir. If you don't plant them, in our part of the world, at least—I can't speak for the United States, but in our part of the world—if you don't make a serious effort at forestry, trash hardwoods take the timber stand over and you simply don't have a harvest after two or three of these inadvertent harvests that you are talking about.

Senator DANFORTH. OK.

Mr. Morgan?

## STATEMENT OF RICHARD E. MORGAN, RESEARCH COORDINATOR, ENVIRONMENTAL ACTION FOUNDATION, ON BEHALF OF ENVIRONMENTAL ACTION, WASHINGTON, D.C.

Mr. MORGAN. Thank you, Mr. Chairman.

I would like to first correct a typographical error in the statement that we submitted. On page 6, near the bottom it reads, "Three billion dollars," and that should read "$1.3 billion."

Mr. Chairman and members of the committee, my name is Richard E. Morgan. I am research coordinator for the energy project of the Environmental Action Foundation. Today I am testifying on Federal tax expenditures for electric utilities on behalf of Environmental Action, Inc., which is an affiliate of Environmental Action Foundation.

Federal tax expenditures for electric utilities are among the highest for major industrial sectors of our economy. This is due, in part, to the unique features of our Nation's electric power industry and in part to special treatment of utilities by the Internal Revenue Code.

I have calculated that tax benefits provided to electric utilities costs the U.S. Treasury over $9 billion annually. The magnitude of these benefits to the power industry is even greater than this figure indicates, due to the federally mandated accounting treatment for certain major tax benefits received by utilities.

The net result of these Federal tax benefits is that approximately one-fourth of all power companies do not pay any Federal income tax in a given year, with most receiving tax refunds.

The entire power industry paid only $1.7 billion in taxes on $17 billion in profits in 1981, which represents an effective tax rate of 10 percent—far lower than for most industrial sectors.

I will briefly review specific tax benefits for electric utilities:

First, utilities receive a 10-percent investment tax credit for investments in new powerplants. This costs the U.S. Treasury about $1.5 billion annually. For the 53 nuclear units currently under construction, the ITC tax expenditures will amount to $12.4 billion, or an average of $220 million per nuclear unit, and this figure does not include the tax expenditures for coal plants which are under construction, for which we do not have comparable figures.

Second, electric utilities can postpone payment of income taxes through accelerated depreciation and shortened tax lives. In 1981, depreciation provisions enabled electric utilities to defer approximately $4.7 billion in Federal and State income taxes. These companies paid only $2.5 billion in deferred taxes from prior years, resulting in a net cost to the U.S. Treasury of approximately $2 billion in 1981.

The accelerated cost recovery system adopted under ERTA includes shortened tax life provisions which are very generous to utilities. A 30-year investment in a coal plant can now be depreciated in 15 years. Nuclear plants receive even more favorable treatment with a tax life of just 10 years.

Electric utilities' deferred-tax accounts are increasing in size, and the power companies appear to be postponing some tax payments indefinitely. At the end of 1981 the power industry was holding over $25 billion in unpaid Federal income taxes. Currently, the combined deferred-tax accounts are increasing by about $4 billion a year.

Third, Section 247 of the Internal Revenue Code allows utilities to deduct a portion of the cost of dividends paid on preferred stock from their taxable income. This unique provision was enacted in 1942 to aid wartime expansion of utility facilities. It has remained in the law for 41 years, despite the apparent lack of any rationale in peacetime. About 30 percent of a utility's preferred stock dividends are deductible under this special provision, costing the Treasury about $300 million annually.

The newest utility tax benefit is the dividend reinvestment program enacted by Congress as part of ERTA. It allows certain utility stockholders to postpone payment of Federal income taxes associated with utility shock dividends, provided that these dividends are reinvested in new stock of that company. This provision helps utilities to raise capital at a reduced cost, but entails a tax expenditure by the U.S. Treasury. One year ago, when this committee voted to eliminate this special program, you expected the program to cost $900 million for 1983 through 1985. Environmental action commends your action last year and urges a similar initiative this year.

Finally, electric utilities can reduce their tax liability through the interest expense deduction. That saved approximately $5.3 billion in 1981.

While the focus of the hearing today is on tax expenditures, the full benefit of the tax code for the utilities goes far beyond reduced tax payments. Currently, the Internal Revenue Code requires that utility tax benefits receive normalized accounting treatment, requiring utilities to charge their ratepayers for taxes as if no tax credits are available. We found overcharges of $3.7 billion by electric utilities in 1981.

In conclusion, the current network of Federal tax benefits to the electric utility industry is costly both to the Federal Treasury and to consumers. Environmental action urges the Finance Committee to consider the following changes in the Internal Revenue Code as it pertains to electric utilities: First, reduce or eliminate the investment tax credit for electric utilities; second, equalize the tax lives for all generating plants at a minimum of 15 years in order to eliminate the bias against coal plants in the current law; third, eliminate special preferences for utilities in the tax code such as the deductions for preferred stock dividends and the dividend reinvestment provision; fourth, remove the full 10-percent investment tax credit from the depreciation base; and fifth, remove Federal restrictions on the ability of State utility commissions to determine the appropriate accounting procedure to be used for electric utility tax benefits.

Thank you for this opportunity to share with you our views on the tax treatment of electric utilities.

[The prepared statement of Richard E. Morgan follows:]

### PREPARED STATEMENT OF RICHARD E. MORGAN, RESEARCH COORDINATOR, ENVIRONMENTAL ACTION FOUNDATION, ON BEHALF OF ENVIRONMENTAL ACTION, INC.

Mr. Chairman and members of the Senate Finance Committee, my name is Richard E. Morgan. I am Research Coordinator for the Energy Project of the Environmental Action Foundation. My business address is 724 Dupont Circle Building, Washington, D.C. 20036.

Today I am testifying on behalf of Environmental Action, Inc., which is an affiliate of Environmental Action Foundation. I appreciate this opportunity to present the views of Environmental Action of federal tax expenditures for electric utilities.

Federal tax expenditures for electric utilities are among the highest for major industrial sectors of our economy. This is due in part to the unique features of our nation's electric power industry and in part to special treatment of utilities by the Internal Revenue Code.

Based on preliminary unpublished figures supplied by the U.S. Department of Energy (DOE), I have calculated that tax benefits provided to electric utilities cost the U.S. Treasury over $9 billion annually. The magnitude of these benefits to the power industry is even greater than this figure indicates due to the federally mandated accounting treatment for certain major tax benefits received by utilities.

The net result of federal tax benefits received by electric utilities is that approximately one fourth of all power companies do not pay any federal income tax in a given year, with most of these companies receiving tax refunds. In 1980, for instance, 51 of the 200 private electric utilities reported paying no federal income tax. (Source: U.S. Dept. of Energy, "Status of Private Electric Utilities in U.S.," 1980).

The entire power industry paid only $1.7 billion in taxas on $17 billion in profits in 1981, according to unpublished preliminary figures provided by DOE. This represents an effective tax rate of 10 percent in 1981, far lower than for most industrial sectors. By comparison, the Joint Committee on Taxation reports 1981 effective tax rates of 48 percent for motor vehicles; 46 percent for trucking; 36 percent for pharmaceuticals; 31 percent for tobacco; 30 percent for diversified services; 29 percent for electronics, appliances and beverages; 27 percent for food processors; 25 percent for office equipment; 24 percent for industrial and farm equipment 23 percent for retailing; 17 percent for diversified financial; and 16 percent for airlines.

Tax benefits received by electric utilities have increases substantially in recent years. In 1954, electric utilities paid 12.7 percent of their gross revenues to the federal government as income taxes, according to the Federal Power Commission's "Statistics of Privately Owned Utilities". By 1981, federal income tax payments had dropped to less than 1.5 percent of gross revenues, according to unpublished data from DOE.

Let us briefly consider the major source of tax benefits received by electric utilities.

*Investment Tax Credit.* Like all other businesses, private utilities receive a 10 percent federal tax credit for investments in new machinery. Since virtually the entire expense of building a new power plant qualifies for the ITC, a utility may subtract 10 percent of the plant cost from its tax liability.

To illustrate the magnitude of this tax benefit, let us consider recent data on the cost of the 53 nuclear units currently under construction, compiled by Salomon Brothers Inc. (Mark D. Luftig and Mo Ying Wong, "Electric Utility Quality Measurements—Quarterly Review", April 12, 1983). In mixed current dollars, the average cost per kilowatt is $2200 which, for the average 1000 megawatt plant, reflects a $2.2 billion investment. This creates a tax expenditure of $220 million per average nuclear unit. Turning to the aggregate cost of $124 billion for nuclear units under construction, the Environmental Action Foundation has concluded that federal ITC tax expenditures of $12.4 billion will be required for the current utility nuclear construction program. While the foundation does not at present have comparable figures for the coal units under construction, we can state generally that tax expenditures will be substantial, but lower than for nuclear units due to the lower capital cost of coal units.

*Accelerated Depreciation and Shortened Tax Lives.* Electric utilities derive substantial benefits from the provisions of the Internal Revenue Code which allow postponement of tax payments through accelerated depreciation and shortened tax lives. While rapid depreciation is available to all businesses, the capital-intensive nature of electric utilities allows them to defer major portions of their income tax liability.

The Accelerated Cost Recovery System adopted in the Economic Recovery Tax Act of 1981 includes shortened tax life provisions which are very generous to utilities. Under the law, a 30-year investment in a coal plant can be depreciated in 15 years. Nuclear plants receive even more favorable treatment with a tax life of just 10 years. We are not aware of any specific justification for this difference in tax lives in the legislative history which would indicate a federal preference for one form of technology over another.

In 1981, depreciation provisions for all income taxes enabled the electric utilities to defer approximately $4.7 billion in income taxes. These companies paid only $2.5 billion in deferred income taxes from prior years, resulting in a net cost to the U.S. Treasury of $2 billion in 1981. (Source: unpublished DOE figures on electric utilities for 1981.)

The tax deferral figures for 1981 are hardly unique. Tax expenditures in preceeding years amounted to $2 billion in 1980; $1.9 billion in 1979; $1.6 billion in 1978; and $1.5 billion in 1977. Thus while there have been substantial tax expenditures each year, there has been a trend of increasing cost to the U.S. Treasury.

Although theoretically these deferred taxes will all eventually be paid to the U.S. Treasury, government figures indicate that utilities deferred tax accounts are increasing in size and that utilities appear to be postponing some tax payments almost indefinitely. At the end of 1981, power companies were holding $16.7 billion in their deferred tax accounts and $8.4 billion in their deferred investment tax credit accounts, according to preliminary figures from DOE. Thus, at the end of 1981, the power industry was holding over $25 billion in unpaid taxes. Currently, the combined deferred tax accounts are increasing by about $4 billion each year.

In addition to tax credits and depreciation benefits, the Internal Revenue Code contains provisions which are designed specifically to benefit utilities. A discussion of these benefits follows.

*Preferred Stock Dividend Deductions.* Section 247 of the Internal Revenue Code allows utilities to deduct a portion of the cost of dividends paid on preferred stock from their taxable income. This unique provision was enacted in 1942 to aid wartime expansion of utility facilities. It has remained in law for 41 years, despite the apparent lack of any rationale in peacetime. About 30 percent of a utility's preferred stock dividends are deductible under this special provision, which the Foundation estimates to cost the treasury $300 million annually.

*Dividend Reinvestment Program.* This newest utility tax benefit was enacted by Congress as part of the Economic Recovery Tax Act of 1981. The dividend reinvestment program allows certain utility stockholders to postpone payment of federal income taxes associated with utility stock dividends, provided that these dividends are reinvested in new stock of that company. This provision helps utilities raise capital at a reduced cost, but entails a tax expenditure by the U.S. Treasury. One year ago when this Committee voted to eliminate this special program, you expected the program to cost $900 million for 1983–85. Environmental Action commends your action last year, and urges similar initiative this year.

Utilities receive still further benefits from provision of the tax code which are available to all businesses, particularly from the interest expense deduction.

*Interest Expense Deduction.* The capital structure of the electric utility industry enables it to take greater advantage of interest expense deductions than other corporate sectors. While any business which raises capital by issuing bonds can deduct the interest paid on this long-term debt, utilities raise more than half of their external capital through long-term debt, compared to only 10–15 percent for most industries (Source: Christopher P. Davis, "Federal Tax Subsidies for Electric Utilities: An Energy Policy Perspective," *Harvard Environmental Law Review*, 4:2, 1980). Utilities are thus uniquely able to deduct the costs of more than half of their long-term financing. The Foundation estimates that this provision of the Internal Revenue Code saved electric companies an estimated $5.3 billion in 1981. This tax expenditure on behalf of electric utilities should be considered when overall tax expenditures for this industrial sector are evaluated.

*Depreciation Basis Adjustment.* The inclusion of any portion of the Investment Tax Credit in the depreciation base provides tax benefits to any capital-intensive industry such as electric utilities. This Committee addressed this matter as part of its consideration of the Tax Equity and Fiscal Responsibility Act of 1982, which resulted in half of the ITC being removed from depreciation base. As long as 50 percent of the ITC is allowed to remain in the depreciation base, the tax expenditure for electric utilities should be calculated and included in assessing the overall tax expenditures for electric utilities.

*Benefits from Tax Normalization.* While the focus of the hearing today is on tax expenditures, the full benefit of the tax code for utilities goes beyond their reduced tax payments. Currently, Sections 46(f) and 167(l) of the Internal Revenue Code require that utility tax benefits receive normalized accounting treatment. This requires utilities to charge their ratepayers for taxes as if no tax credits or deferrals had been received. Consumers and many regulators prefer an accounting alternative known as "flow-through", whereby a utility passes its tax savings on to consumers without delay. This practice is not allowed by current federal law.

A utility normalizes its ITC benefits from a new power plant by charging its customers as if there were no tax credit. The utility keeps these deferred ITC's in a special account. This money is refunded to ratepayers over the life of the plant, a process which may take forty years.

Savings from accelerated depreciation and shortened tax lives are normalized by a different method. The utility charges its customers as if there were no tax deferrals. The taxes owed to the Internal Revenue Service are placed in a deferred tax account and held there until deductible expenditures are insufficient to allow further deferral of tax payments. These funds are available to the utility for its investment in new power plants.

In a report released just last week by the Environmental Action Foundation, we surveyed the nation's one hundred largest power companies and found that the tax overcharges amounted to $3.7 billion in 1981, as a result of the normalization requirement. These unpaid taxes have come to be known as "phantom taxes," a term originating with former Federal Power Commission Chair Howard Morgan.

Our survey found that the electric utilities studied had billed ratepayers for $5.0 billion in federal income taxes in 1981, but reported paying only $3 billion to the Internal Revenue Service. Thus, for every dollar paid to the government, the companies retained about $3.00. Commonwealth Edison Co. in Illinois, for example, charged its customers $208 million for federal income taxes, but recorded paying only $12 million to the IRS, resulting in an overcharge of $196 million. In addition, the company was holding over $1.4 billion in its deferred tax accounts at the end of 1981, according to the company's annual report filed with the Federal Energy Regulatory Commission (FERC). For each of the 100 utilities which we surveyed, the tax overcharge and accumulated deferred tax amounts are listed in the table included as Exhibit 1 of our testimony. The ten highest ranking utilities in phantom tax charges and the ten highest in the size of their accumulated deferred tax accounts are listed as Exhibit 2.

Another provision contained in Section 46(f) allows utilities to profit further from the normalization of its tax benefits. First, the federal law requires utility ratepayers to provide capital for ten percent of a new power plant through the normalization of ITC's. Second, the law allows utilities to select a method of normalization whereby they can include the portion of the plant financed by the ITC in the ratebase and thus earn a profit on funds provided by ratepayers. Regulators generally favor a procedure called "economic normalization," which requires that the ITC be deducted from the rate base. Deferred taxes arising from accelerated depreciation and shortened tax lives are generally deducted in this way.

Environmental Action Foundation has estimated that these extra profits currently amount to about $1 billion annually for the electric industry and that the sum will increase to about $4 billion annually by the 1990's. This additional tax benefit to utilities needs to be considered when the tax expenditures are evaluated by Congress for this segment of our economy.

State utility regulators are quite concerned that federal restrictions on the regulatory treatment of utility tax benefits prevent them from properly exercising their regulatory responsibilities. The collection of phantom taxes and the additional profit derived from the tax code should not be outside the purview of state regulators. The National Association of Regulatory Utility Commissioners has advocated repeal of Sections 46(f) and 167(l) of the Internal Revenue Code for many years. While state regulators do not necessarily oppose the use of normalization, they object to having their regulatory functions interfered with the federal government.

Most of these tax subsidies for electric utilities were adopted at a time when the power companies were engaged in a large expansion program to meet a rapidly growing demand for electricity. Times have changed. The growth in power demand has been declining over the past ten years and has now come to a virtual standstill. The power industry currently has a record 39 percent generating reserve margin. This excess generating capacity is costing consumers billions of dollars in higher electric bills, yet the federal government continues to offer the utilities billion-dollar incentives for investing in new power plants.

These federal tax benefits encourage inefficient management by the power companies. By providing a large pool of cost-free capital, phantom taxes make the financing of new construction artifically inexpensive. Moreover, the perpetual postponement of taxes gives utilities an incentive to keep expanding and building new power plants, to avoid paying their accumulated deferred taxes. Power companies often become locked into a growth cycle which is difficult to break out of. According to former California utility regulator Robert Batinovich: "The desire for tax credits often undermines the responsibility of prudent utility management to determine whether growth is reasonable in light of foreseeable customer requirements. The present tax laws stimulate growth regardless of need within a particular service territory." (Quoted from "A Sensible Substitute for the Federal Income Tax of Utilities," in *Public Utilities Fortnightly*, July 21, 1977, pp. 13–14.)

Many tax experts have questioned the wisdom of offering investment incentives to a regulated monopoly. As Rep. Al Ullman pointed out in 1962: "In view of the fact that utilities are regulated monopolies with guaranteed rates of return and with a utility responsibility to provide all the investment needed to meet demand, I can see absolutely no reason for offering them a tax incentive to do what they are required to do anyway." (*Congressional Record*, v. 108, p. 5319, 1962)

In fact, when the ITC was orginally proposes in 1962, Treasury Secretary Douglas Dillon argued that utilities should be exempted from this provision. In that year, Congress adopted a 7 percent ITC, but limited tax credits for utilites to 3 percent. Not until 1975, when Congress increased the ITC to 10 percent, were utilities allowed the same ITC as other industries.

*Conclusion.* The current network of federal tax benefits to the electric utility industry is costly both to the federal treasury and to consumers. Further, it encourages inefficient utility management decisions to pursue expensive means of meeting future generating needs at a time when least-cost approached should be vigorously pursued. During this period of mounting deficits, the federal government should not be offering over $9 billion annually in investment incentives to companies which are already required by law to make the investment necessary to provide adequate service. Environmental Action urges the Finance Committee to consider the following changes in the Internal Revenue Code as it pertains to electric utilities:

1. Reduce or eliminate the ITC for electric utilities;
2. Equalize the tax lives for all generating plants at a minimum of 15 years, in order to eliminate the bias against coal plants in the current law;
3. Eliminate special preferences for utilities in the tax code, such as the deduction for preferred stock dividends and the dividend reinvestment provision;
4. Remove the full 10 percent ITC from the depreciation base;
5. Remove federal restrictions on the ability of state utility commissions to determine the appropriate accounting procedures to be used for electric utility tax benefits.

Thank you for this opportunity to share with you our views on the tax treatment of electric utilities.

Exhibit 1

ELECTRIC UTILITY PHANTOM TAXES 1981[a]

| UTILITY | RANK BY KWH SALES | TAXES PAID[b] ($) | TAXES CHARGED[c] ($) | TAX OVERCHARGE[d] ($) | OVER-CHARGE RANK ($) | ACCUMULATED DEFERRED TAXES[e] ($) | ACCUMULATED DEFERRED TAX RANK ($) |
|---|---|---|---|---|---|---|---|
| ALABAMA PWR CO | 11 | -17790786 | 83787946 | 101578732 | 9 | 540271804 | 11 |
| APPALACHIAN PWR CO | 13 | 5042409 | 42176514 | 37134105 | 39 | 115208567 | 62 |
| ARIZONA PUB SERV CO | 50 | 8205862 | 12790916 | 4585054 | 94 | 17933717 | 100 |
| ARKANSAS PWR + LT CO | 25 | 6469069 | 57337906 | 50868837 | 23 | 279552020 | 23 |
| ATLANTIC CITY ELEC CO | 94 | 13950679 | 24994094 | 11043415 | 76 | 100991603 | 66 |
| BALTIMORE GAS + ELEC CO | 35 | 57281854 | 86699932 | 29418078 | 48 | 259666899 | 27 |
| BOSTON ED CO | 55 | -7080867 | 60249845 | 67330712 | 16 | 326005844 | 21 |
| CAROLINA PWR + LT CO | 14 | -5292895 | 107344543 | 112637438 | 5 | 544636655 | 9 |
| CENTRAL HUDSON GAS + ELEC CO | 95 | 6099117 | 11550400 | 5451283 | 89 | 31860716 | 96 |
| CENTRAL ILLINOIS LT CO | 98 | 14271300 | 28289391 | 14018091 | 70 | 171120300 | 43 |
| CENTRAL ILLINOIS PUB SERV CO | 72 | 5045306 | 37395420 | 32350114 | 44 | 221326936 | 37 |
| CENTRAL LOUISIANA ELEC PWR CO | 99 | 4723506 | 6452458 | 1728952 | 97 | 61679969 | 83 |
| CENTRAL MAINE PWR CO | 87 | -1084580 | 8318434 | 9403014 | 79 | 75954115 | 80 |
| CENTRAL PWR + LT CO | 45 | 21205000 | 53843478 | 32638478 | 43 | 249980294 | 30 |
| CINCINNATI GAS + ELEC CO | 43 | 68213344 | 118798091 | 50584747 | 24 | 169253188 | 46 |
| CLEVELAND ELEC ILLUM CO | 36 | 7492146 | 67574752 | 60082606 | 18 | 261556817 | 26 |
| COLUMBUS + STHRN OHIO ELEC CO | 49 | 2637951 | 31321232 | 28683281 | 50 | 96885870 | 68 |
| COMMONWEALTH ED CO | 3 | 12022387 | 208122034 | 196099647 | 1 | 1407817721 | 1 |
| CONNECTICUT LT + PWR CO | 63 | -1310593 | 27902140 | 29212733 | 49 | 65533899 | 82 |
| CONSOLIDATED ED CO OF NY | 15 | 190900000 | 203710000 | 12810000 | 73 | 541567865 | 10 |
| CONSUMERS PWR CO | 20 | -6664307 | 21281145 | 27945452 | 51 | 692525477 | 6 |
| DALLAS PWR + LT CO | 56 | 29822422 | 48431634 | 18609212 | 64 | 127280463 | 61 |
| DAYTON PWR + LT CO | 68 | 5793200 | 52418200 | 46625000 | 30 | 96868500 | 69 |
| DELMARVA PWR + LT CO | 78 | 10585446 | 33957579 | 23372133 | 59 | 106705832 | 65 |
| DETROIT ED CO | 10 | 4200067 | 64226581 | 60026514 | 19 | 562398467 | 8 |
| DUKE PWR CO | 5 | 12927338 | 118792022 | 105864684 | 8 | 745613561 | 5 |
| DUQUESNE LT CO | 47 | 8995287 | 56950553 | 47955266 | 26 | 272391473 | 24 |
| FLORIDA PWR + LT | 7 | 33669757 | 148243740 | 114573983 | 4 | 951709801 | 2 |
| FLORIDA PWR CORP | 32 | 10973817 | 65131712 | 54157895 | 22 | 438157875 | 15 |
| GEORGIA PWR CO | 6 | 7912364 | 116492679 | 108580315 | 7 | 920542097 | 3 |
| GULF PWR CO | 89 | 8588533 | 22074262 | 13485729 | 71 | 128108040 | 59 |
| GULF STATES UTIL CO | 16 | 7962331 | 31183186 | 23220855 | 60 | 320833911 | 22 |
| HARTFORD ELEC LT CO | 90 | 412425 | 15716744 | 15304319 | 68 | 34619297 | 94 |
| HAWAIIAN ELEC CO | 97 | 11819572 | 19003128 | 7183556 | 86 | 86931597 | 75 |
| HOUSTON LIGHTING + PWR CO | 4 | 44167628 | 165981342 | 121813714 | 3 | 607159791 | 7 |
| IDAHO PWR CO | 58 | 1836000 | 18878884 | 17042884 | 66 | 135948574 | 55 |
| ILLINOIS PWR CO | 46 | 15116181 | 71392833 | 56276652 | 20 | 345467526 | 20 |
| INDIANA + MICHIGAN ELEC CO | 24 | 6543980 | 50780721 | 44236741 | 31 | 252835968 | 29 |
| INDIANAPOLIS PWR + LT CO | 70 | 12368975 | 29318327 | 16949352 | 67 | 160827984 | 51 |
| JERSEY CENTRAL PWR + LT CO | 52 | -7462293 | 15019338 | 22481631 | 61 | 229589429 | 34 |
| KANSAS CITY PWR + LT CO | 73 | 4703827 | 40433965 | 35730138 | 41 | 175898066 | 42 |
| KANSAS GAS + ELEC CO | 77 | 3317000 | 7645000 | 4328000 | 95 | 87169244 | 73 |
| KANSAS PWR + LT CO | 89 | 3875813 | 28202826 | 24327013 | 58 | 152411476 | 53 |
| KENTUCKY PWR CO | 86 | 996289 | 8455223 | 7458934 | 85 | 56257783 | 86 |
| KENTUCKY UTILITIES CO | 65 | 5205971 | 31190167 | 25984196 | 55 | 165282167 | 48 |
| LONG ISLAND LIGHTING CO | 48 | 1885862 | 85879083 | 83993221 | 10 | 114306869 | 63 |
| LOUISIANA PWR + LT CO | 22 | 11495772 | 66444984 | 54949212 | 21 | 203973069 | 39 |
| LOUISVILLE GAS + ELEC CO | 76 | 5790501 | 33339288 | 27548787 | 52 | 171016100 | 44 |
| MASSACHUSETTS ELEC CO | 61 | 17129855 | 22079155 | 4949300 | 91 | 82697176 | 77 |
| METROPOLITAN ED CO | 75 | 22090359 | -13805347 | -35895706 | 100 | 134739886 | 56 |

| UTILITY | RANK BY KWH SALES | TAXES PAID[b] ($) | TAXES CHARGED[c] ($) | TAX OVERCHARGE[d] ($) | OVER-CHARGE RANK ($) | ACCUMULATED DEFERRED TAXES[e] ($) | ACCUMULATED DEFERRED TAX RANK ($) |
|---|---|---|---|---|---|---|---|
| MINNESOTA PWR + LT CO | 71 | 4416992 | 30842576 | 26425584 | 54 | 132987204 | 57 |
| MISSISSIPPI PWR CO | 82 | 16717540 | 25469435 | 8751895 | 81 | 110289959 | 64 |
| MISSISSIPPI PWR + LT CO | 67 | 18545713 | 20408420 | 1862707 | 96 | 93747154 | 70 |
| MONONGAHELA PWR CO | 57 | 12303210 | 17033127 | 4729917 | 93 | 56823863 | 85 |
| MONTANA PWR CO | 74 | -737069 | 7085009 | 7822078 | 83 | 78257686 | 79 |
| NEVADA PWR CO | 91 | 5933457 | 18795445 | 12861988 | 72 | 34139972 | 95 |
| NEW ORLEANS PUB SERV CO | 92 | 7088000 | 5360005 | -1727994 | 99 | 46277261 | 91 |
| NEW YORK STATE ELEC + GAS CO | 62 | 6511400 | 43844000 | 37332600 | 37 | 90024148 | 71 |
| NIAGARA MOHAWK PWR CO | 12 | 6996000 | 46277595 | 39281595 | 36 | 170713000 | 45 |
| NORTHERN INDIANA PUB SERV CO | 51 | -16323708 | 52131355 | 68455063 | 15 | 391257014 | 17 |
| NORTHERN STATES PWR CO (MINN) | 27 | 57228488 | 87569881 | 30341393 | 47 | 484948686 | 12 |
| OHIO ED CO | 29 | 0 | 71658531 | 71658531 | 13 | 151393477 | 54 |
| OHIO PWR CO | 9 | 5213248 | 17852808 | 12639560 | 74 | 130554865 | 58 |
| OKLAHOMA GAS + ELEC CO | 28 | 16770000 | 64521461 | 47751461 | 28 | 228064560 | 36 |
| PACIFIC GAS + ELEC CO | 2 | 41054639 | 80483606 | 39428967 | 35 | 50167581 | 89 |
| PACIFIC PWR + LT CO | 23 | -5058860 | 4699046 | 9757906 | 78 | 60703733 | 84 |
| PENNSYLVANIA ELEC CO | 60 | 17567442 | 18730321 | 1162879 | 98 | 164887461 | 49 |
| PENNSYLVANIA PWR + LT CO | 26 | 15611134 | 46850616 | 31239482 | 46 | 230874562 | 33 |
| PHILADELPHIA ELEC CO | 18 | 25220922 | 101418421 | 76197499 | 12 | 483537971 | 13 |
| PORTLAND GENERAL ELECTRIC CO | 39 | 6530993 | 43637801 | 37106808 | 40 | 69045122 | 81 |
| POTOMAC ED CO | 54 | 14021868 | 22767660 | 8745792 | 82 | 86193645 | 76 |
| POTOMAC ELEC PWR CO | 37 | 19560388 | 67200494 | 47640106 | 29 | 264498714 | 25 |
| PUBLIC SERV CO OF COLORADO | 42 | 20445000 | 62543227 | 42098227 | 32 | 167311322 | 47 |
| PUBLIC SERV CO OF INDIANA | 33 | 7456000 | 70941413 | 63485413 | 17 | 459281545 | 14 |
| PUBLIC SERV CO OF NEW HAMPSHIRE | 88 | -1579568 | 24381351 | 25960919 | 56 | 45698429 | 92 |
| PUBLIC SERV CO OF NEW MEXICO | 93 | 13040450 | 19265255 | 6224805 | 87 | 127918028 | 60 |
| PUBLIC SERV CO OF OKLAHOMA | 40 | -22415640 | 25396224 | 47811864 | 27 | 258043266 | 28 |
| PUBLIC SERV ELEC + GAS CO | 17 | 6188309 | 118736935 | 112548626 | 6 | 813923610 | 4 |
| PUGET SOUND PWR + LT CO | 38 | 4064748 | 24329000 | 20264252 | 63 | 87041947 | 74 |
| ROCHESTER GAS + ELEC CORP | 84 | 3421445 | 18580504 | 15159059 | 69 | 55032742 | 87 |
| SAN DIEGO GAS AND ELEC CO | 66 | -2971035 | 22189418 | 25160453 | 57 | 18200812 | 99 |
| SOUTH CAROLINA ELEC + GAS CO | 59 | 5521700 | 54449068 | 48927367 | 25 | 233614580 | 32 |
| SOUTHERN CALIFORNIA ED CO | 1 | 33950492 | 161346383 | 127395891 | 2 | 247710562 | 31 |
| SOUTHWESTERN ELEC PWR CO | 44 | 15939100 | 43472175 | 27533075 | 53 | 215808075 | 38 |
| SOUTHWESTERN PUB SERV CO | 53 | 69210 | 21200245 | 21131035 | 62 | 89080337 | 72 |
| TAMPA ELEC CO | 64 | 25460101 | 34758766 | 9298665 | 50 | 176018607 | 41 |
| TEXAS ELEC SERV CO | 31 | 53356311 | 90550528 | 37194217 | 38 | 228280221 | 35 |
| TEXAS-NEW MEXICO POWER CO | 96 | -833593 | 3996339 | 4829932 | 92 | 25240741 | 98 |
| TEXAS PWR + LT CO | 19 | 56879211 | 97628114 | 40748903 | 33 | 364102870 | 18 |
| TOLEDO ED CO | 79 | 8578784 | 40841609 | 32262825 | 45 | 99192274 | 67 |
| TUCSON ELEC PWR CO | 81 | -17283000 | 16897603 | 34180603 | 42 | 79654249 | 78 |
| UNION ELEC CO | 21 | -7946000 | 69260406 | 77206406 | 11 | 361406000 | 19 |
| UTAH PWR + LT CO | 41 | 5131300 | 45345883 | 40214583 | 34 | 203497949 | 40 |
| VIRGINIA ELEC + PWR CO | 8 | 22753784 | 93669272 | 70915488 | 14 | 435640899 | 16 |
| WASHINGTON WATER PWR CO | 69 | 4686709 | 10447888 | 5761179 | 88 | 27918601 | 97 |
| WEST PENN PWR CO | 30 | 26672763 | 44261553 | 17588790 | 65 | 153917069 | 52 |
| WEST TEXAS UTILITIES CO | 100 | 3523900 | 8865200 | 5341300 | 90 | 50568015 | 88 |
| WISCONSIN ELEC PWR CO | 34 | 31556383 | 41684287 | 10127904 | 77 | 163127822 | 50 |
| WISCONSIN PWR + LT CO | 80 | 23119218 | 30688718 | 7569500 | 84 | 42038204 | 93 |
| WISCONSIN PUB SERV CORP | 83 | 7721300 | 18873000 | 11151700 | 75 | 46436680 | 90 |
| TOTAL |  | 1288739560 | 4963036181 | 3674297120 |  | 22076133592 |  |

Exhibit 2

**Top Ten: Electric Utility Phantom Taxes, 1981**

| | | |
|---|---|---|
| 1. | Commonwealth Edison Co. | $196.1 million |
| 2. | Southern California Edison Co. | 127.4 million |
| 3. | Houston Lighting & Power Co. | 121.8 million |
| 4. | Florida Power & Light Co. | 114.6 million |
| 5. | Carolina Power & Light Co. | 112.6 million |
| 6. | Public Service Electric & Gas Co. | 112.5 million |
| 7. | Georgia Power Co. | 108.6 million |
| 8. | Duke Power Co. | 105.9 million |
| 9. | Alabama Power Co. | 101.6 million |
| 10. | Long Island Lighting Co. | 84.0 million |

**Top Ten: Accumulated Deferred Taxes and Tax Credits, Dec. 31, 1981**

| | | |
|---|---|---|
| 1. | Commonwealth Edison Co. | $1.408 billion |
| 2. | Florida Power & Light Co. | 952 million |
| 3. | Georgia Power Co. | 921 million |
| 4. | Public Service Electric & Gas Co. | 814 million |
| 5. | Duke Power Co. | 746 million |
| 6. | Consumers Power Co. | 693 million |
| 7. | Houston Lighting & Power Co. | 607 million |
| 8. | Detroit Edison Co. | 562 million |
| 9. | Carolina Power & Light Co. | 545 million |
| 10. | Consolidated Edison Co. of New York | 542 million |

Senator DANFORTH. Senator Long?

Senator LONG. No questions.

Senator DANFORTH. Wouldn't all of these changes simply increase the rates for the consumer?

Mr. MORGAN. Some of the changes would; however, the effect of the accounting treatment, the requirement of using normalization accounting, is costing utility rate payers about $3.7 billion annually. And we have calculated that even with some substantial reductions in the tax benefits that utilities receive, if the State utility commissions were allowed to use flowthrough accounting, which would get rid of these so-called phantom taxes, that that could save ratepayers more than the reduction in the tax benefits, depending on how big that reduction would be.

Senator DANFORTH. Do you think the utilities will be taxed more and they will be charging the consumer less?

Mr. MORGAN. Yes. In fact, that could very well happen if there were reductions in the size of the tax benefits to the utilities, and if at the same time utility commissions were basically given a free hand to determine the accounting procedure to use on tax benefits.

Senator DANFORTH. OK.

Gentlemen, thank you very much, and Senator Long may have some additional questions for you.

Mr. SWIFT. Could I have permission to submit four other documents for the record? Shall we name them, or shall we just submit them?

Senator DANFORTH. No, no.

Mr. SWIFT. Thank you.

[The documents follow:]

*Forest Industries Committee on*
**TIMBER VALUATION AND TAXATION**
1250 Connecticut Avenue, Washington, D.C. 20036
(202) 223-2314

July 21, 1983

The Honorable Senator
Robert J. Dole
Chairman
Committee on Finance
United States Senate
221 Dirksen Senate Office
Building
Washington D.C. 20510

Dear Mr. Chairman:

At your recent hearings on tax expenditures, Senator Metzenbaum referred to a Department of Treasury statement made in 1981 that timber is the "most tax-favored" industry. As this statement is incorrect, since 1981 we have met and corresponded with Treasury Department officials pointing out the flaws in their position.

In this connection, we are enclosing for the record:

1. Letter to Assistant Secretary Chapoton from William K. Condrell, dated December 23, 1981;
2. Letter to Assistant Secretary Chapoton from William K. Condrell, dated September 10, 1982, with attached memorandum.

The December 23, 1981, letter explains in detail why Treasury's argument is specious. That argument is predicated upon three erroneous assumptions -- that timber capital gains treatment results in an unfair benefit to timber owners; that timber owners mismatch items of income and expense; and that the mismatching results in a conversion of ordinary income to capital gains. The letter responds in detail to each of these claims, noting that timber capital gains treatment provides the same treatment to all timber owners as is available to the owners of all other capital assets and to timber owners who dispose of their timber in outright liquidations; that there is no mismatching since the expensing treatment available to timber owners is the same treatment available to all taxpayers; and that since there is no mismatching, there is no conversion of ordinary income into capital gains.

The letter dated September 10, 1982, transmits a memorandum which explains that the Internal Revenue Code provides timber owners no special expensing treatment. The memorandum discusses at length how the general rules concerning expensing have been applied to timber owners.

Additionally, we are enclosing for the record:

3. Response submitted to Congressional Budget Office; and

4. Response submitted to House Democratic Study Group.

These materials, which were prepared in response to base-broading options, explain how timber capital gains treatment promotes equity among owners of all capital assets and owners of timber, and why timber is not inventory or stock in trade. The response to the Congressional Budget Office also disputes the estimates of revenue gains that would be realized were timber capital gains treatment repealed.

Finally, we are also enclosing for the record a copy of a brochure entitled "Timber," which explains the importance of timber capital gains treatment to our economy.

Thank you for your consideration in this matter.

Sincerely,

G. Robin Swift Jr.

G. Robin Swift, Jr.
Chairman
Forest Industries Committee on
Timber Valuation and Taxation

President
Swift Lumber, Inc.

Enclosures

*Forest Industries Committee on*
TIMBER VALUATION AND TAXATION

1250 Connecticut Avenue, Washington, D.C. 20036
(202) 223-2314

December 23, 1981

The Honorable John E. Chapoton
Assistant Secretary for Tax Policy
U.S. Department of Treasury
Washington, D.C.

Dear Mr. Chapoton:

Thank you for taking the time on December 7 to discuss with us concerns which arose as a result of your testimony of November 24 before the Senate Finance Committee.

As we indicated to you at our meeting, we were speaking on behalf of the Forest Industries Committee on Timber Valuation and Taxation (FICTVT), which consists of over 5,000 timberland owners, and which represents the more than 5,000,000 timberland owners in the nation.

As we stated at that time, we are not now urging an immediate increase in the limitation on expenditures eligible for reforestation incentives. While it is the FICTVT's policy that these limits be increased as Senator Packwood has proposed, it is recognized that now may not be the proper time.

In any event, our immediate purpose in writing to you is to confirm our discussions of December 7th. This letter will consider and respond to each of the four items --

1. capital gains;
2. mismatching of income and expense;
3. conversion of ordinary income into capital gains; and
4. minimum tax provision,

which some in Treasury have inappropriately described as causing the timber industry to be one of the "most tax-favored" industries, and as a result of which, Treasury has indicated that timber owners should be ineligible for more effective reforestation incentives. Our comments in this regard will include responses with respect to several of the additional points that you raised at our meeting.

Briefly, our comments show (a) that timber capital gains treatment reflects Congressional desire to give timber owners the same treatment as others entitled to capital gains treatment regardless of which of the various types of timber dispositions are employed; (b) that there is generally no "mismatching" of timber expenses and income; (c) that there is no conversion of ordinary income into capital gains; and (d) the minimum tax argument is irrelevant to the discussion of reforestation incentives.

## I. Capital Gains

With respect to capital gains, the prepared statement submitted on behalf of the Treasury Department stated:

> "[U]nder the tax laws, amounts received by manufacturers and producers for the sale of their products are generally taxed as ordinary income. However, a taxpayer may elect to treat the cutting of timber as the sale or exchange of a capital asset, with the result that receipts from timber sales are generally taxed at the preferential capital gains rate. Taxation at capital gains rates reduced the taxes of the timber industry by an estimated $350 million in 1978."1/

In considering these comments, it is important to recognize at the outset that when a timber owner makes an outright sale of standing timber, he is disposing of a

---

1/ Statement of the Honorable John E. Chapoton, Assistant Secretary for Tax Policy, Department of Treasury, Before the Subcommittees on Taxation and Debt Management and International Trade of the Senate Finance Committee 3 (Nov. 24, 1981) (hereinafter cited as "Treasury Statement").

capital asset,2/ and accordingly is treated the same as the owner of any capital asset.

However, prior to the adoption of the special provisions for timber capital gains in 1944, if a timber owner cut his timber for sale, he had to pay taxes at ordinary income tax rates on whatever gain resulted. For example, an owner who cut and then sold his timber was taxed at a higher rate than if he sold the timber outright and let the purchaser come on his lands to do the cutting.

Similarly, under prior law, if a timber owner cut his timber for use in his business, he paid tax at ordinary income tax rates on both the appreciation inherent in the timber before it was cut and the value added after cutting. For example, a sawmill operator who owned standing timber and cut it for use in his sawmill had to pay the higher ordinary income tax rates on both the appreciated standing timber and increased value as a result of processing. Thus, as a practical matter, the sawmill operator who owned standing timber would have been better off selling his timber outright, and then buying logs from another landowner as needed in his mill. In this way, he would obtain capital gains treatment for the appreciation inherent in his standing timber, and would be subject to ordinary income tax on profit attributable to the logging and conversion.

---

2/ With the exceptions noted below, an outright sale of standing timber gives rise to capital gains treatment, since standing timber is a capital asset under I.R.C. § 1221, unless the standing timber is deemed to be used in a trade or business. I.R.C. § 1221(2). In such case, an outright sale of standing timber obtains capital gains treatment under I.R.C. § 1231, since it is real property used in a trade or business. (Standing timber is uniformly treated as real property under state law. See, e.g., 73 C.J.S. Property, § 7c, p. 160, § 8, p. 174-75; 98 C.J.S. Woods & Forests, § 2, pp. 688-89.). Note that I.R.C. § 1231 would apply independent of I.R.C. § 1231(b)(2) (relating to Section 631 transactions), since an outright sale of such timber is not covered by Section 631.

Regardless whether I.R.C. § 1221 or I.R.C. § 1231 applies, capital gains treatment will be available only if the standing timber was held for one year (I.R.C. §§ 1222(3), 1231(b)(1)), and if it was not held primarily for sale to customers in the ordinary course of a trade or business (I.R.C. §§ 1221(1), 1231(b)(1)(B)).

Equity was achieved in 1944 by the enactment of Section 117(k), the predecessor to Section 631(a) and (b). As a result, an owner who cuts his timber or disposes of it under contract obtains the same treatment as an owner who sells his timber outright. The appreciation inherent in the standing timber is taxed at capital gains rates. This is the proper tax result since the net economic result of each of these transactions is the same.. In contrast to prior law which resulted in an incentive for outright liquidations, the present law results in effective tax policy by removing a penalty against holding and managing timber for long-term growth.

Thus, timber owners receive the same treatment as others entitled to capital gains treatment regardless of which of the various types of timber transactions are employed. This treatment provides a uniform and consistent tax policy.

## II. Mismatching Of Income And Expense

The prepared testimony submitted on behalf of the Treasury Department stated:

> "[A] basic principle of the tax laws is that an expenditure may not be currently deducted if it is related to the purchase or production of an asset that will generate income beyond the year in which the expenditure is made. Thus, the cost of producing inventory for resale is not currently deducted but is reflected in income as an offset against the selling price of the goods in the year of sale. However, for the timber industry, there is a significant exception in that costs incurred in connection with growing and carrying timber after the reforestation period are currently deducted against ordinary income. These costs represent approximately 3/4 of the costs of raising timber. The amortization of reforestation expenditures is another exception to the basic tax

> principle. In theory, the expenses incurred in the reforestation period and beyond should be capitalized and recovered against the income to which they relate in later years when the timber is cut or sold."3/

The proposition that it is "a basic principle of the tax laws that an expenditure may not be currently deducted if it is related to . . . production of an asset that will generate income beyond the year in which the expenditure is made" is incorrect. It belies the clear Congressional intent to allow certain deductions on an annual basis for all taxpayers, including timber growers, regardless of when the asset will generate income.4/

The general rule of the Code is that expenditures incurred to acquire, create or establish a capital asset are to be capitalized.5/ On the other hand, expenditures for the maintenance of a capital asset are to be expensed.6/ The Code clearly entitles all taxpayers to deduct currently their interest expenses 7/ and property taxes.8/ Maintenance expenses are deductible annually if they are ordinary and necessary expenses either incurred in a trade or business or incurred for the management, conservation or maintenance of property held for the production of income.9/ These

---

3/ Treasury Statement 3.

4/ *See* I.R.C. §§ 162(a), 212.

5/ *See* I.R.C. § 263(a)(1). Some expenditures permitted to be expensed may be capitalized. I.R.C. § 266; Treas. Reg. §1.266.1.

6/ I.R.C. §§ 162(a), 212.

7/ I.R.C. § 163(a).

8/ I.R.C. § 164(a)(1)-(2). For a limited exception to this rule, see I.R.C. § 189 (requiring the capitalization and amortization of interest and taxes for real property during its construction period).

9/ I.R.C. §§ 162(a), 212(2).

are the rules applicable to all taxpayers. That timber owners receive this treatment does not stem from any timber-oriented provision of the Code. There is no basis for subjecting timber owners to a different rule.

Since taxes, interest, and maintenance costs are paid to discharge annual obligations, their treatment as expenses is fully in accord with the proper application of the above principles. They are current expenses which if not paid could result in the total loss or diminution in value of the underlying asset. Clearly, they must be paid to maintain such asset and it would be inappropriate to capitalize such costs.

The application of these principles does not require the matching of items of income and expense. Owners of any capital asset not earning current income are permitted to expense the cost of maintaining their asset. For example, the costs of maintaining idled factory buildings and warehouses or unproductive land may all be expensed. Similarly, the owner of several rental properties, one of which is vacant, is able to deduct maintenance expenses incurred for the vacant property against the rents received from other properties. And the owner of a growth stock portfolio yielding no annual income may annually deduct custodial fees from his other income, despite the fact that no dividends are received from his portfolio. In a like vein, a timberland owner is permitted to deduct the annual costs of disease and fire control and similar expenses, despite the fact that the trees remain unharvested. (We will be sending under separate cover a memorandum which expands upon, and provides the legal authorities for, the expensing available to timber owners).

It is also important to note that a timber owner often possesses more than the right to harvest the trees on his land: Timber ownership may confer the rights to all uses of the property. For timberland, these uses often include hunting, farming, grazing, mining, and watering rights; additionally, certain trees on the property may yield turpentine or maple syrup. Where the timberland owner uses or rents his property for any of these uses, such uses benefit from many of the maintenance expenses incurred with respect to the property. For example, interest expenses, property taxes, fire control expenses, and surveying costs for the boundaries of the property benefit all uses of the property. This is significant because each of these other uses often produces income currently. To such extent, the timing of income and expenses does coincide even under the theoretical notions being urged by the Treasury Department.10/

At our meeting, you suggested that despite the foregoing, the policy underlying the completed contract method of accounting might suggest that the deduction for maintenance expenses for standing timber should be deferred until the timber is sold or cut. A comparison between the treatment of timber owners and the completed contract method of accounting provides no precedent for deferring timber management expenses.

Essentially, the completed contract method of accounting may presently be used only in the case of a long-term contract, which is defined to mean "a building, installation, construction or manufacturing contract which is not completed within the taxable year in which it is entered into."11/ The adoption of this method, which is elective,12/ enables a taxpayer to defer recognizing any income on progress payments received until the contract is

---

10/ In any event, those expenses incurred to acquire, create, or establish an asset are to be capitalized. This is precisely the practice followed by timber owners for reforestation expenditures. In this regard, it is in error to suggest that Section 194, which permits amortization of a limited amount of reforestation expenditures over 7 years, somehow violates "a basic principle" of tax law. It is consistent with the treatment which is available to all business taxpayers.

In fact, under the recently adopted ACRS regime, the cost of most property can now be recovered over 5 years, despite the fact that the economic life may be substantially longer. This concept is not new; ACRS merely liberalizes the recovery previously available under the ADR system. While Section 194 also permits accelerated cost recovery for timber owners, it occurs to a more limited extent: Reforestation expenditures may be amortized over 7 years, while the cost of most other property may be recove[illegible] over 5 years under ACRS.

11/ Treas. Reg. § 1.451-3(b).

12/ Treas. Reg. § 1.453-3(a).

completed.13/ As the quid pro quo for this income deferral, certain expenses otherwise deductible are required to be deferred.14/ Such expenses include direct material and labor costs, as well as certain indirect costs required to be allocated to the contract.15/ At the time the contract is completed, all deferred income and expenses are required to be taken into account.16/

In considering the completed contract method of accounting, it is important to recognize that it is an elective accounting method designed to postpone the time income is deemed received; its principal purpose is not to defer the time that deductions may be taken. This is evidenced by the fact that this accounting method is authorized by the regulations enacted under Section 451, entitled "General Rule for Taxable Year of Inclusion;" this accounting method is not even mentioned in Section 461, entitled "General Rule for Taxable Year of Deduction," or the regulations thereunder, nor is it mentioned in the remainder of Subchapter E, Part II, Subpart C, entitled "Taxable Year for Which Deductions Taken."

And of equal importance, the significance of timber maintenance expenses is quite different from the expenses deferred under the completed contract method. In those instances where the completed contract method is applied, the contractor is adding value to the project which is the subject of the contract. For example, a contractor erecting a stadium is furnishing labor and materials directly in connection with the creation of the stadium.

This is in marked contrast to that which occurs in the case of timber. A major portion of the expenses incurred prior to the time the standing timber reaches maturity --

---

13/ Treas. Reg. § 1.451-3(d)(1).

14/ *See id.*

15/ Treas. Reg. § 1.451-3(d)(5).

16/ Treas. Reg. § 1.451-3(d)(1).

taxes and interest -- adds nothing to the value or growth.[17/] The expenses which the timber owner incurs for maintenance (*e.g.*, fire control, disease protection, rodent and insect control, and the like), in and of themselves do not add value to the standing timber.[18/] Rather, they merely permit future growth of the standing timber through the forces of nature. Thus, the policy underlying the completed contract method of accounting has little relevance to the expenses incurred in connection with timber growth.

Finally, it is important to note that timber companies treat maintenance costs as expenses on their tax returns and on their books (financial statements). This can be contrasted with other industries which may defer expensing similar costs on their financial statements (thereby increasing both income and assets for book purposes), while they take the expenses currently for tax purposes (thereby decreasing income and assets on their tax returns).

It is thus apparent that there is generally no "mismatching" of timber expenses and income.

## III. Conversion of Ordinary Income Into Capital Gains

In the Treasury Department's prepared remarks, it was stated:

> "The combination of the two benefits described above result in the conversion of ordinary income into capital gains. The costs of growing and carrying timber are currently deducted against other ordinary income of the timber company, while the income produced by those

---

[17/] In this connection, it should be noted that even where the completed contract method applies, interest is not deferred but remains deductible in full. Treas. Reg. § 1.451-3(d)(5)(iii)(D).

[18/] *See* Rev. Rul. 71-228, 1971-1 C.B. 53 ("shearing, rather than improving or *increasing the value* of the trees simply maintained and preserved the[ir] marketability.")

> expenses is taxed at the capital gains rates."19/

The central premise underlying this argument is faulty in that it is entirely dependent upon the ill-conceived mismatching argument discussed above. As the mismatching argument is specious, the conversion argument is also without substance. In this connection, it cannot be overly emphasized that this so-called "conversion" is the same for all owners of capital assets who deduct maintenance costs currently; it affords no special advantage to timber owners.

Furthermore, it must also be noted that the conversion argument ignores the time value of money. The significance of this omission might be illustrated by an example, which, incidentally, was used in a study undertaken by the Treasury Department during the Carter Administration, upon which the conversion argument appears to be based:

> "[A] corporation is engaged in both timber growing and in logging or manufacturing. An expense of $100 in the timber growing operation can be deducted against revenue from logging or manufacturing in computing net taxable income. If the $100 expense eventually produces $100 of revenue from the sale of timber, the corporation's taxable capital gain increases by $100. Because the corporate income is taxed at a 46 percent marginal rate, while the corporate capital gain is taxed at a 28 percent rate, the expense, which produced a net income of zero has created a tax savings of $18."20/

---

19/ Treasury Statement 3-4.

20/ Office of Tax Analysis, U.S. Dept. of Treasury, Federal Tax Policy and Recycling of Solid Waste Materials" 35 (1979) (emphasis in original).

This illustration, which on its face appears persuasive, falls completely apart when the time value of money is taken into account. In the example, the taxpayer will receive $72 when he sells his timber ($100 of revenue less $28 of taxes). The when part of the equation is critical. The present value today of money received in the future is, of course, considerably less than the face amount of the money that is received. For example, assuming an interest rate of 10 percent (modest by today's standards), the equivalent value today of $72 received 15 years from now is only $17.24; if the $72 is received 20 years from now, its value today is $10.70; and if received 30 years from now it is worth only $4.13. These after-tax future returns must be compared to the after-tax current outlay which, in the example, is $54 ($100 of expenses less $46 of tax savings). Thus, the current dollar loss on this investment would range from $36.75 to $49.87. The conversion argument simply ignores the fact that it takes time to grow a tree.

## IV. Minimum Tax

Finally, the Treasury Department's prepared remarks stated:

> "In addition, timber growing receives special treatment under the corporate minimum tax provisions of the Code. In 1976, Congress increased the minimum tax rate from 10 to 15 percent and eliminated both the carry-over of regular taxes as an offset and the $30,000 exemption. Timber, however, was not subject to these changes."[21]

While this statement is partially true for corporations, its inclusion in the context of the consideration of S. 1824 is misleading. It is clear that the principal beneficiaries of the reforestation incentives are individual timber owners not corporations.22/ The special provisions of the minimum tax relative to timber by their terms do not apply to individuals, who thus do not enjoy the suggested advantage.

---

[21] Treasury Statement 4.

* * *

In conclusion, we believe that the foregoing discussion illustrates (a) that timber capital gains treatment reflects Congressional desire to give timber owners the same treatment as others entitled to capital gains treatment regardless of which of the various types of timber dispositions are employed; (b) that there is generally no "mismatching" of timber expenses and income; (c) that there is no conversion of ordinary income into capital gains; and (d) the minimum tax argument is irrelevant.

As indicated during our meeting, when you have had an opportunity to review the contents of this letter, we would appreciate the opportunity to meet with you again.

Sincerely,

William K. Condrell
Steptoe & Johnson
General Counsel

---

22/ See Senate Committee on Finance, Subcommittee on Taxation and Debt Management Generally, Hearing on S.100, 96th Cong., 1st Sess. 20 (1979) (Testimony of Daniel I. Halperin, Deputy Assistant Secretary (Tax Legislation)).

*Forest Industries Committee on*
**TIMBER VALUATION AND TAXATION**
1250 Connecticut Avenue, Washington, D.C. 20036 (202) 223-2314

September 10, 1982

Honorable John Chapoton
Assistant Secretary
U.S. Department of
 the Treasury
15th Street and Pennsylvania Ave., N.W.
Washington, D.C. 20220

Dear Mr. Chapoton:

At our meeting several months ago, you requested a paper showing those costs of a timber operation that might be expensed and those that were required to be capitalized.

As a result, we have prepared the enclosed paper which explains, with authorities, how the various expenditures involved in a timber operation might be treated. Also, we have included a chart summarizing the paper's contents as an executive summary.

I believe you will agree after reviewing this material that the timber "expensing" rules are the same as for other kinds of expenditures. Thus, you can understand our view that there is no special "tax benefit" or preference due to expensing of timber costs. If that is so, then the figures Treasury has been using leading to the statement that timber is "the most tax favored" industry--even one of the most tax favored--is in our opinion erroneous.

If after reviewing the paper you should have any questions, we would be pleased to meet with you to review them.

Sincerely,

William K. Condrell
Steptoe & Johnson
 Chartered
General Counsel

WKC:jj
Enclosure

*Forest Industries Committee on*

**TIMBER VALUATION AND TAXATION**

1250 Connecticut Avenue, Washington, D.C. 20036

(202) 223-2314

## COSTS OF A TIMBER OPERATION:
## CAPITALIZING VERSUS EXPENSING

## EXECUTIVE SUMMARY

### COSTS OF TIMBER OPERATIONS
### EXPENSING VERSUS CAPITALIZING

| ITEM | EXPENSE | CAPITALIZE |
|---|---|---|
| **GENERALLY** | | |
| Interest | Yes[1] | Optional[4] |
| Taxes | Yes[2] | Optional[4] |
| Depreciation | Yes[3] | No |
| **PLANTING & REFORESTATION** | | |
| Site preparation | No | Yes[5] |
| Cost of seed or seedlings | No | Yes[5] |
| Labor and tool expenses, including depreciation on equipment | No | Yes[5] |
| **MANAGEMENT** | | |
| Silvicultural practices (after establishment) | Yes[6] | No |
| Disease and pest control | Yes[7] | No |
| Fire protection expenses | Yes[7] | No |
| Insurance | Yes[7] | No |
| Labor and professional costs re management | Yes[7] | No |

| ITEM | EXPENSE | CAPITALIZE |
|---|---|---|
| MANAGEMENT (Con't) | | |
| Costs of materials & supplies | Yes[7] | No |
| CHRISTMAS TREE OPERATIONS | | |
| Pruning and Shearing | Yes[8] | No |
| TIMBER CRUISE | | |
| In connection with purchase | No | Yes[10] |
| For management | Yes[9] | Optional[4] |

## EXPLANATORY NOTES

1/ I.R.C. § 163. For taxpayers other than corporations, if interest attributable to making or carrying on investment, annual deduction limited to $10,000 plus investment income for the year (without regard to long-term capital gains).

2/ I.R.C. § 164. Federal income and excise taxes, estate gift and inheritance taxes and local assessments which increase the value of the property assessed are not deductible. See Willamette Valley Lumber Co. v. U.S.; Union Bag-Camp Paper Corp. v. U.S. (ad valorem taxes)

3/ I.R.C. §§ 167, 168. Depreciation for tangible property placed in service prior to 1981 and non-tangible property is available under I.R.C. § 167 and is computed on the basis of the property's useful life; depreciation for tangible property placed in service after 1980 is available under I.R.C. § 168 and is computed over the applicable accelerated cost recovery period. However, depreciation on tools and equipment used in planting or reforestation must be capitalized. See note 5, *infra*.

4/ Under I.R.C. § 266, carrying charges (*i.e.*, expenditures for taxes, interest, and other necessary expenditures for development of the real property. Treas. Reg. 1.266-1(b)(1)), may at the taxpayer's election be capitalized.

5/ Rev. Rul. 75-467. Howevet, at the taxpayer's election, up to $10,000 of annual reforestation expenses may be recovered over seven years. I.R.C. § 194.

[6] Rev. Rul. 66-18; Barham v. U.S.

[7] I.R.C. §§ 162, 212; Wilmington Trust Co. v. U.S.; Union Bag-Camp Paper Corp. v. U.S.

[8] Ransburg v. U.S.; Kinley v. Comm'r.

[9] Robinson Land & Lumber Co. v. U.S.

[10] *See* Rev. Rul. 68-28 (recovered on sale of property).

## COSTS OF A TIMBER OPERATION: CAPITALIZING VERSUS EXPENSING

### INTRODUCTION

The question of which costs of a timber operation should be capitalized and which should be expensed is a very important one. At the outset, it must be noted that this matter is not covered by section 631, but is governed by other sections of the Code. These other sections contain no specific language relating to expenditures incurred in acquiring, improving, managing, and operating timber properties. Rather, they are sections generally applicable to all taxpayers and businesses. A brief review of these sections, the cases decided thereunder, and the administrative policies of the Internal Revenue Service is pertinent to a better understanding of the treatment of expenditures involved in a timber operation.

### GENERAL PROVISIONS OF THE CODE

Section 263 provides that amounts expended for permanent improvements or betterments made either to increase the value of property or to restore or make good the exhaustion of property for which depreciation, amortization, or depletion is allowed are not deductible in computing taxable income. Such amounts are considered "capital expenditures."[1/] A rule of

---

[1/] I.R.C. § 263(a).

thumb is that where such improvements or betterments have a useful life of more than one year, then will be considered capital expenditures.[2/]

Section 162 of the Code allows corporate and individual trades or businesses to deduct all "ordinary and necessary expenses".[3/] Section 212 provides a similar allowance for individuals in the case of expenses incurred in managing, conserving or maintaining property held for the production of income.[4/]

Interest on indebtedness is deductible under Section 163. However, if incurred by a taxpayer other than a corporation for the purpose of making or carrying an investment, the interest deduction is limited to $10,000 plus the amount of investment income for the year.[5/] In determining income from investments, long-term capital gains are excluded.[6/]

Taxes in general are deductible under section 164. However, certain taxes, such as federal income and excise taxes, estate, gift and inheritance taxes, and local assessments which increase the value of the property assessed are not deductible.[7/]

---

[2/] See Treas. Reg. § 1.263(a)-2(a).

[3/] I.R.C. § 162(a).

[4/] I.R.C. § 212(2).

[5/] I.R.C. § 163(d)(1).

[6/] See I.R.C. § 163(d)(3)(B).

[7/] I.R.C. § 164(a), (c)(1).

Sections 167 and 168 provide the means through which the cost of certain capital expenditures may be recovered. Section 167 provides a deduction for depreciation for the exhaustion wear and tear of property either used in a trade or business or held for the production of income. Section 168, which is applicable only to tangible property placed in service after 1980, permits a liberalized depreciation deduction under the Accelerated Cost Recovery System.

These are the Code provisions generally applicable. It would be difficult to enumerate all possible expenditures by timber owners to which these provisions apply and to classify them as either capital expenditures or deductible expenses. We can, however, articulate some guidelines which distinguish those items which should be capitalized from those which should be expensed.

## PLANTING AND REFORESTATION EXPENSES

Direct costs incurred in connection with reforestation by planting are capital expenditures.[8] The Internal Revenue Service has ruled that such planting costs include:

---

[8] Treas Reg. § 1.611-3(a); Barham v. U. S., 301 F. Supp. 43 (D. Ga. 1969), *aff'd*, 429 F.2d 40 (5th Cir. 1970); Chapman & Dewey Lumber Co. v. U.S., 238 F. Supp. 869 (W.D. Tenn. 1965), *rev'd on other grounds*, 359 F.2d 495 (6th Cir. 1966); Belcher v. Patterson, 60-2 U.S. Tax Cas. ¶ 9733 (N.D. Ala. 1960), *rev'd on other grounds*, 302 F.2d 289 (5th Cir. 1962); Rev. Rul. 75-467, 1975-2 C.B. 93; Rev. Rul. 66-18, 1966-1 C.B. 59. *See also* I.R.C. § 126 for a limited exception regarding the treatment of such expenditures when reimbursed via cost sharing payments; and I.R.C. § 194 for the election to amortize reforestation expenditures not exceeding $10,000 annually.

(a) preparation of the site, including any girdling, herbicide applications, baiting of rodents, or brush removal work to afford good growing conditions;

(b) cost of seed or seedlings; and

(c) labor and tool expense, including depreciation of equipment such as tractors, trucks, tree planters and similar machines used in planting or seeding.[9]

In discussing planting costs, the Service has also stated:

> Brush removal work performed a year or two after planting is considered to be proximately related to the establishment of the seedlings. Such work is essentially a part of the planting operation, and its cost should be capitalized. The cost of seedlings includes the amount expended for those purchased and those planted and raised by the taxpayer. The labor and tool expense includes all costs involved in planting the seedlings, including all amounts expended for transportation, supervision and labor, equipment rental and depreciation of owned equipment and tools used in connection with the planting. The portion of the depreciated cost of equipment thus added to the basis of the seedlings should be proportionate to the use of the equipment or tools in planting as compared with the use of such equipment or tools in other activities. . . .[10]

---

[9] Rev. Rul. 75-467, 1975-2 C.B. 93, *superseding* Rev. Rul. 55-252, 1955-1 C.B. 319.

[10] Rev. Rul. 66-18, 1966-1 C.B. 59, 61. Although this ruling deals with a Christmas tree operation, it is applicable to other timber operations as well. *See* Barham v. U.S., 301 F. Supp. 43 (D. Ga. 1969), *aff'd*, 429 F.2d 40 (5th Cir. 1970).

A key distinction raised by the foregoing ruling is a difference between "brush removal work" and "silvicultural practices." According to the ruling, brush removal work performed "a year to two" after planting is essentially a part of the planting operation and its cost should be capitalized. On the other hand, the ruling provides that "expenditures for silvicultural practices such as weeding and noncommercial thinning . . . incurred after the trees become established . . . are in the nature of maintenance charges and are deductible as ordinary and necessary trade or business expenses."[11] Cases in which this distinction becomes an issue will very likely be decided on the basis of the timing of the brush removal work.

In the case of Barham v. United States,[12] it was held that the clearing of unwanted oak trees and brush (with no commercial value) from around young but well established pine trees was equatable to a "silvicultural practice" which, under the above revenue ruling was a deductible business expense. The court stated that if the pine trees around which the brush control procedures were carried out were not well established and growing, the expenses of brush control would have had to have been capitalized as being in the nature of planting expenses.

---

[11] Id.

[12] 301 F. Supp. 42 (D. Ga. 1969), aff'd, 429 F.2d 40 (5th Cir. 1970).

Expenditures for destroying undesirable hardwood trees have also been the subject of a recent ruling of the Service.[13] This revenue ruling involved a taxpayer who was the owner of land containing stands of loblolly-short leaf pine trees, as well as a number of hardwoods. The taxpayer's method of reforestation was to attempt natural regeneration, but if after three to five years an adequate stocking of pine seedlings had not been achieved, the taxpayer would resort to artificial reforestation. In connection with the latter, the taxpayers would eliminate or control the undesirable hardwood trees as part of preparing the site for seeding. When natural regeneration is accomplished, the eradication of hardwood trees is undertaken when the young pine growth is from three to seven years old. The taxpayer used mechanical or chemical methods to destroy or weaken undesirable hardwoods. This included the use of a manually operated poison injector. The control procedures used by the taxpayer were a one time endeavor rather than a recurring type of activity. Based on the foregoing facts the Internal Revenue Service found that the expenditures incurred by the taxpayer in hardwood control were capital expenditures. The Service held that the taxpayer's hardwood control activities accomplished the same purpose as the "girdling" referred to in Rev. Rul. 75-467, and are comparable to the site preparation work referred to in Rev. Rul. 66-18.[14/]

---

[13] Rev. Rul. 76-290, 1976-2 C.B. 188.

EXPENSES OF CHRISTMAS TREE OPERATION

The distinction between the costs of a tree growing business which must be capitalized and those which may be deducted as ordinary and necessary business expenses is often a very narrow one, and can lead to relatively long-term disagreements between the Internal Revenue Service and the industry involved. A good example of this was the disagreement over the proper tax treatment of costs incurred for the shearing and basal pruning of trees grown for the Christmas tree market.

In 1966, the Service issued Rev. Rul. 66-18,[15/] which stated the Service's view regarding the tax treatment of several expenditures involved in the growing of Christmas trees. As noted earlier[16/] although directly applicable only to Christmas trees, this ruling contains expressions of opinion by the Service regarding issues of capitalization versus business expense which are relevant as well to standard timber operations.

---

14/ 1966-1 C.B. 59. See also Peterson v. Commissioner, 29 T.C.M. 802 (1970).

15/ 1966-1 C.B. 59.

16/ See pp. 3-4, supra.

Among the expenditures discussed in Rev. Rul. 66-18 were those incurred for basal pruning and shearing. The Service treated these the same as costs of planting and concluded as follows:

> [I]n the planting and cultivation of Christmas trees as a trade or business the expenditures incurred for planting, basal pruning, stump culture, and shearing must be capitalized and added to the basis of the standing trees.[17]

The Service's position regarding pruning and shearing expenditures was challenged in two cases, Ransburg v. United States,[18] which was decided by the United States District Court for the Southern District of Indiana, and Kinley v. Commissioner,[19] which was decided by the Tax Court. In both cases, the courts agreed with the taxpayers that the costs of pruning and shearing of Christmas trees were ordinary and necessary business expenses rather than capital expenditures. The Service appealed the Kinley decision to the United States Court of Appeals for the Second Circuit, but that court upheld the Tax Court's decision in favor of the taxpayers.[20] Subsequently, the Service issued Rev. Rul. 71-228[21] which modifies Rev. Rul. 66-18 as it applies to pruning and shearing expenses. The new ruling concludes:

---

[17] 1966-1 C.B. 59, 61-62.

[18] 281 F. Supp. 324 (S.D. Ind. 1969).

[19] 51 T.C. 1000 (1969).

[20] 70-2 U.S. Tax Cas. ¶ 9462 (2d Cir. 1970).

[21] 1971-1 C.B. 53.

> The decision in Kinley is premised upon the Tax Court's findings of the unique conditions present in the Christmas tree industry. The Tax Court found that the sole use of the trees grown by the petitioner was for ornamental Christmas trees and that the seedlings planted by the petitioner were planted as Christmas trees. Under this view of the facts, the shearing did not adapt the trees to any use other than their use as Christmas trees. The court found that shearing, rather than improving or increasing the value of the trees, simply maintained and preserved the marketability of the trees as ornamental Christmas trees.
>
> Upon reconsideration of the issue, the Service accepts the court's characterization of the ultimate facts involved.
>
> Accordingly, based on the trees being planted and grown as Christmas trees rather than being converted into Christmas trees, the costs incurred for the shearing and basal pruning of trees grown for the Christmas tree market are deductible business expenses under section 162 of the Code.22/

## COST OF TIMBER CRUISE

Whether the cost of a timber cruise is a capital expenditure or a deductible expense depends on when and for

---

22/ Id.

what purpose the cruise is taken. The cost of a timber cruise incurred by the purchaser in connection with a purchase of timber is a capital expenditure, to be treated as part of the cost of the timber.[23] On the other hand, the cost of a cruise taken subsequent to a purchase for the purpose of determining, among other things, the types, quantities, location, and growth possibility of timber, is a deductible business expense.[24]

### AD VALOREM TAXES

Taxpayers who are required to pay state or local ad valorem taxes may often deduct the amount of such taxes under either section 164, which allows a deduction for state, local and foreign real property taxes, or section 162, which allows a deduction for all the ordinary and necessary expenses incurred in carrying on a trade or business.[25]

In some instances, it may be found that ad valorem taxes are paid by the taxpayer as part of the cost of timber or other property and thus must be added to the basis of the property and recovered through depletion or at the time of the property's sale. Thus far, two timber cases have involved this question, and in both cases the courts have found that the taxes were not part of the cost of timber and therefore were deductible.

---

[23] It has been held that a taxpayer, not otherwise in the timber business, is not entitled to any deduction (loss, expense, or otherwise) for the cost of cruise taken in connection with a contemplated purchase which never takes place. Brown v. Comm'r, 40 T.C. 861 (1963). However, a loss deduction would have apparently been allowed, if the purchase had been made and then abandoned.

[24] Robinson Land & Lumber Co. v. U.S., 112 F. Supp. 33 (S.D. Ala. 1953).

[25] McMullan v. U.S., 78-2 U.S. Tax Cas. ¶ 9656, n.2.

In Williamette Valley Lumber Co. v. United States,[26] the taxpayer purchased standing timber under a contract which permitted it to use the land on which the timber was located to obtain access to other timber it was cutting. The contract, which was executory in nature, required the taxpayer to pay the ad valorem taxes on both the timber and the land. The taxes were paid in the first instance by the land owner, who subsequently billed the taxpayer for these amounts. The Government contended that the amounts disbursed by the taxpayer in payment of the taxes represented an additional cost of the timber and as a consequence were not deductible. The court rejected this contention and held (1) that the taxpayer was entitled to deduct the taxes on the timber under section 164 (the court noted that under Oregon law, an executory contract for the sale of timber amounts to the conveyance of an interest in timber and consequently the taxes on the timber were properly imposed upon and paid by the taxpayer), and (2) that the taxpayer was entitled to deduct the taxes on the land under section 162 (the court found that the payment of the taxes on the land, was a condition to the taxpayer's use of the land to obtain access to other timber, and thus, the amounts paid represented ordinary and necessary business expenses.)

---

[26] 252 F. Supp. 199 (D. Or. 1966).

The second case which involves the question of the deductibility of ad valorem taxes is Union Bag-Camp Paper Corp. v. United States.[27] In that case, the taxpayer entered into a long-term lease of timberlands and agreed as a part of the lease agreement to pay the ad valorem taxes on the leased land. The Government's contention that the amount of such taxes should be capitalized as part of the cost of the timber was rejected by the court. The payment of the taxes, the court held, should be deemed to constitute "rental or other payments required to be made as a condition to the use or possession of property" and should therefore be deductible as a business expense.

## MISCELLANEOUS EXPENSES

Other timber capital expenditures include those for acquisition of land and timber, cutting rights, and extension of cutting rights; legal, abstract, title search, and survey costs in connection with such acquisitions; permanent improvements to the land, depreciable and nondepreciable; construction of fire lanes, bridges, trestles, etc.; and for equipment having more than a year's useful life and for repair of such equipment that prolongs its useful life.

---

[27] 325 F.2d 730 (Ct. Cl. 1963).

Other deductible expenses include costs of disease and pest control; fire protection expenses; insurance; interest on timber loans and mortgages; yield and severance taxes payable at time of cutting; labor and professional costs related to management; costs of materials and supplies, etc.[28/]

## CARRYING CHARGES

Many of the deductible expenses above mentioned fall into a category of costs that although normally expensed may be capitalized at the taxpayer's election. These include taxes and a broad category of expenditures known "carrying charges."[29/] Although the expression "carrying charges" is not defined, the historical development of timber depletion regulations and the pertinent provision of the law make it clear such charges include annual taxes, interest, and costs

---

28/ See, e.g., Wilmington Trust Co. v. U.S., 610 F.2d 703, 705 (Ct. Cl. 1980) (disease, and pest control; labor and professional costs relating to timber management; Union Bag-Camp Paper Co. v. U.S., 325 F.2d 730, 741 (Ct. Cl. 1963) (salaries, supplies, repairs, and insurance).

29/ I.R.C. § 266; Treas. Reg. § 1.266-1.

of administration and protection of timber properties, whether such properties are improved or unimproved, productive or nonproductive. This is borne out by Treasury Form T (Timber), which mentions "expenditures for taxes, administration, protection, interest actually paid, etc." as additions to the timber depletion basis where they have not been treated as deductions.

The right to capitalize administration, protection and carrying charges does not, of course, work in reverse to permit a taxpayer to expense what is clearly a capital item.

## DEPRECIATION ALLOWANCES

Deductions for depreciation allowances may be taken with respect to property that has a limited and determinable life. These are designed to return to the taxpayer his invested capital free of tax.

The regulations under Section 611 authorize a deduction of a reasonable allowance for depreciation in case of improvements peculiar to timber.[30] Under this authority, the alternative methods of depreciation permissible under section 167 are made applicable to timber improvements.[31] In addition, such improvements may be depreciated under the "unit of production" method, that is, over the life of the timber being operated.[32]

---

[30] Treas. Reg. § 1.611-5(a).

[31] *Id.*

[32] *Id.*

Where permanent improvements to the land involve depreciable features, such as roads that are graveled or surfaced, bridges, trestles, culverts, lookout towers, fences, etc., the capital invested is recoverable through the annual depreciation allowance.

For tangible property placed in service after 1980, depreciation will generally be determined pursuant to the Accelerated Cost Recovery System provided by section 168, rather than under the methods provided by section 167. However, a taxpayer otherwise eligible to use the unit of production method for any property may continue to do so by electing to exclude such property from Section 168's application.[33]

---

[33] I.R.C. § 168(e)(2).

6/26/83

# RESPONSE TO CONGRESSIONAL BUDGET OFFICE'S OPTION TO REPEAL TIMBER CAPITAL GAINS

## Introduction

Earlier this year, the Congressional Budget Office (CBO) released its annual report on budget options to the Senate and House Budget Committees. Part Three of this report, entitled "Reducing the Deficit: Spending and Revenue Options" contains, among the 35 options considered, the repeal of timber capital gains.

CBO, which claimed that repeal of timber capital gains would result in increased revenues of $3.1 billion from 1984 to 1988, described this option in three paragraphs. The first purported to explain the tax advantage provided by timber capital gains; the second gave the arguments of advocates of repeal; and the last claimed to give arguments on behalf of defenders of timber capital gains.

We believe that not only are the revenue estimates attributible to timber capital gains in gross error, but also that there are serious inaccuracies and omissions in each of the three paragraphs. These points will be discussed below.

## Revenue Estimates

CBO estimates that the anticipated revenues from the repeal of timber capital gains would produce $200 million in FY 1984, $600 million in FY 1985, $700 million in FY 1986, and $800 million in each of FY 1987 and FY 1988.*/ These estimates appear to be in substantial error.

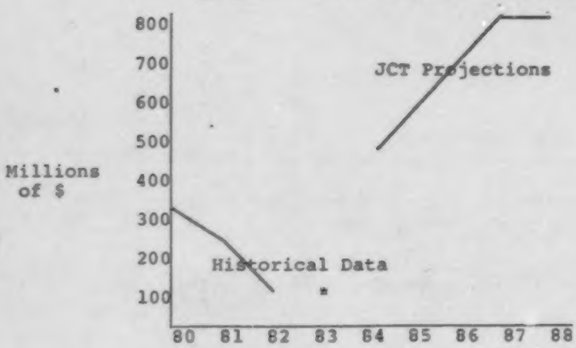
---

*/ The revenue estimates used by CBO appear to be the tax expenditure estimates made by the staff of the Joint Committee on Taxation, rounded off to the nearest $100 million. Presumably due to CBO's assumption that the option for repeal would be implemented mid-year, however, the CBO's revenue estimate for FY 1984 is below the FY 1984 tax expenditure estimate of $500 million made by the JCT staff.

Data from a forest industries committee survey indicates that the tax benefit from timber capital gains treatment is significantly below these levels. The Forest Industries Committee on Timber Valuation and Taxation estimates on the basis of this survey data that the industrial sector benefited from timber capital gains treatment by approximately $85 million in FY 1982, $175 million in FY 1981, and $220 million in FY 1980. Using the Treasury Department's estimate that 30 percent of all timber capital gains are attributable to individuals -- an estimate of questionable validity, but the only such estimate available -- the industrial sector's benefit from timber capital gains may be extrapolated to determine the total cost of providing timber capital gains treatment: $315 million in FY 1980, $250 million in FY 1981 and $120 million in FY 1982.

In light of this decidedly downward trend, we do not fully understand the assumptions underlying estimates that would indicate a reversal of that trend to the extent that annual tax savings from the repeal of timber capital gains treatment are projected to be up to three and one-half times the average benefit realized during the past three years. Juxtaposing the results from the last three years against the projections results in the following comparison:

REVENUE LOSS ESTIMATED TO RESULT FROM THE REPEAL OF TIMBER CAPITAL GAINS: COMPARISON OF HISTORICAL DATA WITH JCT PROJECTIONS



---

* Not available

While the timber industry is currently recovering from the recession, these projections can hardly be credible since neither the extent nor the duration of the recovery is known.

The CBO estimates appear to be based on historical trends that ignore the experience of recent years. As a result, they are a poor predictor of the revenue increase that may be expected were capital gains repealed.

Also, it appears that CBO is using "tax expenditure" data. "Tax expenditure" estimates do not take into account the interrelationship between capital gains and other provisions, such as minimum taxes. Thus, tax expenditure data is an inappropriate basis for estimating the revenues that would be gained from the repeal of timber capital gains treatment.

In any event, these estimates fail to account for the dynamic effects that would result were timber capital gains treatment repealed.

While short-term effects are unclear, since, among other things, some types of timber liquidation would still be entitled to capital gains treatment under the general rules, nonetheless, in the long-run, repeal clearly will result in a revenue decline since future timber growth will inevitably be curtailed.

## The Advantage of Timber Capital Gains

CBO states that the timber capital gains provisions "[override] the tax code's general denial of capital gains treatment to 'stock in trade . . . or property held primarily for sale to customers in the ordinary course of his trade or business.'" This statement miscontrues the nature of timber.

Stock-in-trade is synomous with inventory and is generally ineligible for capital gains treatment. Typically, stock-in-trade includes shelf items that are held primarily for sale. Stock-in-trade does not include capital assets that are held for productive purposes.

Timber has been a classic capital asset since the concept of distinguishing such assets was installed in the tax code in the early 1920s. The unique provision related to timber converters (Sec. 631) was incorporated in the law simply to provide a mechanical means for consistently applying capital gains treatment to equally-situated timber assets, regardless of whether they were sold or converted into an "inventory-type" asset.

Altering the existing treatment would produce a wholly unjustified discriminatory result. Classifying timber as "stock-in-trade" would impose an ordinary income tax on owners who manage their lands and convert their timber, while owners who simply hold their timber and eventually sell it would be taxed under capital gains rules. This is a serious differential tax result on what are clearly equivalent assets -- precisely the opposite result from that normally sought by sound tax policy.

Under the tax rules as they now stand, the appreciation which occurs in timber while it is in a productive state is distinguished from the increase in value which results from processing. The former, like appreciation on all capital assets, is taxed as capital gains, while the latter, resulting from the conversion process, is taxed as ordinary income.

Finally, there is no legal basis whatever for considering timber as stock-in-trade. Timber, which is uniformly held to be real property, is intrinsically neither stock-in-trade nor inventory. Every court that has considered the matter has refused to classify timber in that way.

In any event, minimal timber is held primarily for sale to customers. The Supreme Court has construed the word, "primarily," to mean in this connection of "first importance" or "principally." Many timber owners, rather than holding their timber "principally" for sale to customers, hold their timber for a general profit motive. And other owners hold timber for conversion into logs or timber products. The taxpayers who hold their timber "primarily for sale to customers" are those few who act as dealers in timber.

## Arguments of Proponents for Repeal

CBO indicates that timber capital gains, "divert investment resources to timber from more productive uses." But absent capital gains treatment, the economics of growing timber are unattractive.

This results first from the inherent substantial front-end investments required for land and planting, the carrying costs, and the 25 to 100 year growing cycle for timber. The effect of these factors is to tie up investments for extended periods without current returns.

Second, the return which is generated is substantially lower than the return for other types of investments.

Third, there are substantial risks, such as fire, insects and disease, and windstorms. The long-term growing cycle of timber results in an increased exposure to such risks far beyond that of other types of investments.

Even with capital gains treatment, the return from investment in timber is marginal. Federal Trade Commission reports indicate that the return on equity from timber and wood products and from paper and allied products is below that available from all durable and non-durable goods produced.

Further, CBO suggests that the assignment of taxable income from other operations to cutting timber arises from improper or questionable practices; rather, taxable income results solely from the determination of fair market value as approved by the Internal Revenue Service.

Moreover, CBO suggests that reforestation incentives benefit the timber "industry." Such incentives, a 10 percent credit and 7-year write-off, are intended to benefit small owners as they cover only the first $10,000 of investment. They were enacted as a supplement to capital gains treatment for smaller owners. The effect of these provisions is slightly less beneficial than the cost recovery benefits available to other business investments (i.e., they provide a 7-year straight line versus a 5-year potentially accelerated write-off). And, timber dispositions in the first ten years trigger total forfeiture of benefits and their recapture as ordinary income, again, a treatment less favorable than the treatment of other investments.

Finally, by noting that capital gains "disproportionately benefits a small number of large timber growing firms," CBO ignores the fact that the benefits of capital gains are proportionate to timber harvests, which in turn, to a large extent, depend upon the degree of timber management and harvesting. It would be equally valid to say that capital gains treatment "disproportionately benefits" tree growers who do most timber management and harvesting.

## Arguments of Proponents of Timber Capital Gains

In the final paragraph of its write-up, CBO purports to give the arguments of the "defenders" of timber capital gains. In so doing, however, it fails to mention, among other things, the depression in timber reinvestment and reforestation that would occur were timber capital gains repealed and the need to promote equity among both timber owners and owners of all other capital assets. Also, while the write-up notes that "treating income from timber sales as ordinary income could promote abuses," the abuses that would occur are not abuses of the tax laws; rather, the repeal of timber capital gains (and concommitant cross-sales of standing timber) would promote bad forestry by encouraging the liquidation of their recently purchased timber.

APPENDIX

## ELIMINATE CAPITAL GAINS TREATMENT OF TIMBER

Income from harvested timber held for at least one year before cutting is taxed at capital gains rather than ordinary income tax rates. This special provision makes clear that timber income is treated as a capital asset and not within the exclusion to capital gains treatment provided for "stock in trade . . . or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." (Without this exclusion, any corporate manufacturer could produce a product, put it on a shelf for one year before selling it, and reduce the tax owed by almost 40 percent.) Repealing this provision would add about $___ billion to federal revenues over the 1984-1988 period.

Advocates of repeal argue that the current large tax preferences for timber divert investment resources to timber from more productive uses. Besides having access to the capital gains tax preference, the timber owners also benefit from two other favorable tax provisions -- the 10 percent investment tax credit and seven-year amortization for up to $10,000 of reforestation expenditures (enacted in 1980). The capital gains preference disproportionately benefits a small number of large timber-growing firms that also produce wood and paper. Absent close IRS scrutiny, these firms can assign some of the taxable income from their other operations to the cutting of timber, thereby increasing their tax savings from the preference.

Defenders of timber capital gains treatment argue that its benefits are essential to stimulate the timber investment and reforestation required to meet our nation's future timber needs. Further, they argue that timber capital gains treatment is necessary to promote equity among timber owners who sell their timber outright receiving capital gains under the general rules, and timber owners who manage their stands. Similarly, they argue that timber capital gains treatment is necessary to promote equity between investments in timber, which historically has a low rate of return, and investments in other capital assets. Finally, the defenders argue that the repeal would be unfair to the timber owners who relied on the availability of timber capital gains when they made their timber investments.

6/2/83

## RESPONSE TO DEMOCRATIC STUDY GROUP'S OPTION TO REPEAL TIMBER CAPITAL GAINS

### Introduction

The House Democratic Study Group (DSG) recently circulated a list of potential tax increase proposals totaling about $60 billion for the fiscal year 1984. Included in this list was a proposed repeal of "timber capital gains." (See full text of the timber paragraph attached.)

The bases upon which DSG proposed repealing timber capital gains were (1) that it was stock-in-trade and (2) that there already were adequate incentives in the law through the 10 percent credit and 7-year amortization provisions (with a $10,000/year cap).

This memorandum will explain why the bases underlying the DSG proposal are without merit.

### Timber is Not Stock-in-Trade

"Stock-in-trade" is synonomous with inventory,* which is generally ineligible for capital gains treatment. Typically, stock-in-trade includes shelf items that are held primarily for sale. Stock-in-trade does not include capital assets that are held for productive purposes.

Timber has been a classic capital asset since the concept of distinguishing such assets was installed in the tax code in the early 1920s. The unique provision related to timber converters (Sec. 631) was incorporated in the law simply to provide a mechanical means for consistently applying capital gains treatment to equally-situated timber assets, regardless of whether they were sold or converted into an "inventory-type" asset.

---

* In any event, minimal timber is held primarily for sale to customers. The Supreme Court has construed the word, "primarily," to mean of "first importance" or "principally." Many timber owners, rather than holding their timber "principally" for sale to customers, hold their timber for a general profit motive. And other owners hold timber for conversion into logs or timber products. The taxpayers who hold their timber "primarily for sale to customers" are those few who act as dealers in timber.

Altering the existing treatment would produce a wholly unjustified discriminatory result. Classifying timber as "stock-in-trade" would impose an ordinary income tax on owners who manage their lands and convert their timber, while owners who simply hold their timber and eventually sell it would be taxed under capital gains rules. This is a serious differential tax result on what are clearly equivalent assets -- precisely the opposite result from that normally sought by sound tax policy.

Under the tax rules as they now stand, the appreciation which occurs in timber while it is in a productive state is distinguised from the increase in value which results from processing. The former, like appreciation on all capital assets, is taxed as capital gains, while the latter, resulting from the conversion process, is taxed as ordinary income.

Finally, there is no legal basis whatsoever for considering timber as stock-in-trade. Timber, is intrinsically neither stock-in-trade nor inventory, and every court that has considered the matter has refused to classify timber in that way.

## Only Small Timber Owners Benefit from the Tax Credit and Amortization

The 10 percent credit and 7-year write-off provisions are intended to benefit small owners as they cover only the first $10,000 of investment. They were never intended to replace timber capital gains. Rather, they were enacted as a supplement to capital gains treatment in order to provide small owners with an additional incentive for reforestation.

Moreover, the effect of these provisions is slightly less beneficial than the cost recovery benefits available to other business investments (i.e., they provide a 7-year straight line write-off versus a 5-year potentially accelerated write-off). And, timber dispositions in the first ten years trigger total forfeiture of benefits and their "recapture" as ordinary income, again, a treatment less favorable than the treatment of other investments.

Attachment

# EXCERPT FROM
# REPORT OF HOUSE DEMOCRATIC STUDY GROUP ON TIMBER CAPITAL GAINS

## ALTERNATIVE REVENUE OPTIONS

### BUSINESS TAX PROPOSALS (Continued)

| | Increased Tax Revenues ($ in BILLIONS) | | |
|---|---|---|---|
| | 1984 | 1985 | 1986 |
| **Eliminate Capital Gains Treatment for Timber:** Current law allows capital gains treatment on the sale of timber held for at least one year prior to cutting. This is contrary to the tax code's general denial of capital gains treatment to "stock in trade"—property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Timber already receives preferential treatment as a result of the 10% investment tax credit and the seven-year amortization for up to $10,000 of reforestation expenditures. | 0.2 | 0.6 | 0.7 |

Senator **Danforth**. Senator Dole may have some other questions for each of you—I'm not sure. But thank you both for being here.

Mr. **Morgan**. Certainly.

Senator **Danforth**. The next panel is Dr. Jack Carlson, executive vice president and chief economist, National Association of Realtors, Washington, D.C.; David Smith, vice president and secretary, National Association of Home Builders, Washington, D.C.; Wallace Woodbury, Woodbury Corp.; and Alan Aronsohn, a tax counsel representing the National Realty Committee.

Mr. Carlson?

## STATEMENT OF DR. JACK CARLSON, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, D.C.

Dr. **Carlson**. On behalf of the 575,000 members of the National Association of Realtors, we are very concerned with the current record Federal budget deficit and those projected for 1984 and beyond. We are disappointed with spending growth twice the inflation rate.

The track chosen by the Congress will crowd out investment in all sectors of the economy, particularly long-lived assets such as commercial, industrial, and residential structures, and raise the fear of inflation in future years, which in turn is already causing and will continue to cause interest rates to rise or remain high and dampen the recovery.

As to the topic of this hearing, we strongly recommend that any tax change should follow the following principles:

Tax policy changes should not adversely affect the recovery. Recoveries are initially driven by investment in housing—nearly one-half of real growth of output, income, and jobs so far has come from housing—and subsequently driven by investment in commercial and industrial structures.

Two, additional taxes should not be placed on savings and investments but rather on consumption, which we have supported for 2 years. Savings and investments are already too high to take care of the growth in the American standard of living and the quality of life in future years.

Three, tax policies affecting savings and investments should change infrequently, to allow businesses and households time to plan and invest over a 5-year business cycle. Changes made in 1981 and 1982 should not be changed now.

Four, public policy should encourage more adequate investment in housing as well as in industry. Public policy continues to discriminate against housing in favor of industry. The effective tax rate on apartment buildings is more than twice the rate on equipment; and if recapture laws are changed, this would be significantly worsened.

Demographic housing trends in the 1980's indicate housing needs comparable to the needs of the 1970's, and we are already behind because of the recession of the last four years.

Five, public policy should encourage homeownership instead of fostering policies that have resulted in a decline in home ownership for the first time in 40 years. During the last 2 years, the

United States has lost half of the gain in homeownership achieved in the whole decade of the 1970's. Homeownership should be encouraged, not discouraged, because of its impact on the quality of life, greater family stability occurs among homeowners; because of *its impact on democracy*, homeowners participate more often and more effectively in neighborhood, community, State, and national decisionmaking; because homeownership provides retirement security, thereby reducing the need to expand Government social security programs in the future; because homeowners save more of their income than renters, and more than just the needs for housing, which benefits both housing and industry; and because of the greater maintenance of existing homes.

In conclusion, if anything, the existing commercial and housing tax provisions are inadequate for the country's needs for the 1980's. Reducing them would slow the recovery, limit growth in the American standard of living, slow the rehabilitation of our cities.

This concludes my statement. I would be pleased to respond to your questions.

[The prepared statement of Dr. Jack Carlson follows:]

### PREPARED STATEMENT OF DR. JACK CARLSON ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS

I am Jack Carlson, Executive Vice President, Executive Staff Officer and Chief Economist of the National Association of Realtors®.

On behalf of the 575,000 members of the National Association of Realtors®, we appreciate the opportunity to present our views on existing tax provisions which directly affect the real estate and housing industry.

Our industry is very concerned with the current record Federal budget deficit and those projected for 1984 and beyond. We are disappointed, as many of you are, with the inability of the Congress to limit spending growth below the 7.4 percent increase in the Congressional Budget Resolution which is well above the initial Budget Resolution of both the President and the Senate and is more than twice the estimated inflation rate.

Thus the track chosen by the Congress will crowd out investment in all sectors of the economy and raise the fear of inflation in future years which in turn will dampen or shorten the recovery.

As to the topic of this hearing, and as to the failure to place adequate limits on spending, we strongly recommend that any tax change should follow the following principles.

1. Tax policy changes should not adversely affect this recovery; the worst recession in 40 years. Recoveries are initially driven by investment in housing and subsequently driven by investment in commercial and industrial structures.
2. Additional taxes be placed on consumption, not savings and investments. Savings and investment are already too low to take care of the growth in the American standard of living and the quality of life in future years, and is well below the standards set by other industrialized countries, many of them are improving their standard of living faster than us.
3. Tax policies affecting savings and investment should be changed infrequently and certainly the changes made in 1981 and 1982 should not be changed significantly because they have not had sufficient time to be implemented, because of recession and high real interest rates, and because on and off again stimulus for investment will result in far less investment. Investment incentives require a five year or more horizon to measure impact and allow for business and households to plan properly.
4. Public policy should encourage more adequate investment in housing. Investment needs have risen during the last several years. Public policy continues to discriminate against housing in favor of industry. Consider that the effective tax rate on apartment buildings is more than twice the rate on equipment.
5. Public policy should encourage homeownership instead of fostering policies that have resulted in a decline in homeownership for the first time in 40 years—in the last two years the U.S. has lost half of the gain in homeownership achieved in the whole decade of the 1970s. Homeownership should be encouraged not discouraged:

(1) Because of its impact on the quality of life—greater family stability occurs among homeowners;

(2) Because of its impact on democracy—homeowners participate more often and effectively in neighborhood, community, state and national decision making;

(3) Because homeownership provides retirement security, thereby reducing the need to expand social security programs in the future;

(4) Because homeowners save more of their income than renters and this benefits society by increasing aggregate wealth, by establishing behavioral patterns of high rates of savings among younger households, and by providing sources of capital for residential and business investment; and

(5) Because of the greater investment and maintenance effort undertaken by owner-occupants which benefits society because the useful life of existing units is prolonged.

The existing real estate and housing tax provisions work as intended. Clearly, Congress would have to devise new ways to assist in the development, renovation and rehabilitation of America's cities if it were to scrap many of today's investment incentives which are already on the books.

The National Association of Realtors® therefore supports the existing homeownership and real estate investment incentives.

## INTRODUCTION

The real estate industry is, as you know Mr. Chairman, a very large and diverse segment of the United States' economy. The basic elements of the industry are concerned with the development of housing and commercial structures and with providing real estate sales servicing and financing.

## ECONOMIC ROLE

The real estate industry has always played a vital role in our national economy. Traditionally it has been the housing industry which not only signals but takes the lead in economic recovery. Clearly, this continues to be true. The real estate industry, particularly housing, is now leading the economy out from the deepest and longest economic recession since the 1930s.

Residential investment is the primary force behind the economic recovery now underway. Residential investment increased at an annualized rate of 39.1 percent during the fourth quarter of 1982 and is increasing by 83.1 percent during the first quarter of this year.

The impact which the real estate industry has on the economy is apparent when considering the following:

(1) Each of the new homes built in 1982 resulted in over $91,000 in Gross National Product (GNP). (See Attachment 1).

(2) Each single-family resale which occurs in 1983 results in almost $11,000 of direct expenditures and over $5,000 of secondary expenditures. Together, each 1983 home resale contributes over $16,000 to GNP. (See Attachment #1).

(3) Total 1983 home resales of 2,700,000 will contribute over $43 billion to GNP and provide 850,000 full time jobs. (See Attachment #2).

(4) Construction of 1,100,000 new single-family homes in 1983 will contribute $96 billion of GNP and provide nearly 2 million full time jobs. (See Attachment #2).

(5) Maintenance, repair, and improvements by residential property owners in 1983 will generate $83 billion in GNP and will result in 1.7 million jobs. Nearly 45 percent of all homeowners are involved in home maintenance and repair projects (See Attachment #2).

(6) Construction of 500,000 new multi-family residential units will contribute $35 billion of GNP and provide 710,000 full-time jobs. (See Attachment #2).

(7) Development of commerical and industrial structures in 1983 will contribute $77 billion to GNP and provide 1.5 million full-time jobs. (See Attachment #2).

(8) In 1983, total economic activity of the real estate industry will represent over 8 percent of GNP and over 5 percent of total employment. (See Attachment #2).

## SOCIAL ROLE

(9) The widespread ownership of homes across the social and economic strata gives society a firm base for individual, decentralized decision-making. Homeownership gives households a stake in society and an incentive to participate in those decisions because they affect their family's well being as well as they value of their property and wealth. There is convincing evidence that homeowners are far more likely than

renters to vote in local elections. Thus, encouraging homeownership and individual property rights helps democrary work better.

(10) Homeownership clearly promotes better citizenship and neighborhood stability in the local community. Homeowners have a greater financial stake in the economic and political well being of society. Thus, encouraging homeownership helps make democracy work better.

(11) Repeated surveys of what constitutes the "good life" in America have found that homeownership is the highest ranking item—84 percent—just above a happy marriage and children.

### DISCUSSION OF TAX INCENTIVES

Because of the uniquely beneficial economic and social role demanded of the real estate industry, Congress has, over the years, enacted tax provisions to encourage homeownership and real estate investment. Included are provisions to allow the tax deductibility of home mortgage interest and real property depreciation and, under certain circumstances, the deferral or exclusion of capital gains on home sales. Congress has also provided tax credits for amounts spent to rehabilitate income producing and historic buildings.

These tax provisions encouraging homeownership and real estate investment resulted from a variety of reasons, and Mr. Chairman, the National Association of Realtors® believes that for equally compelling reasons these provisions should not now be altered.

For example, taxpayers traditionally have been allowed a cost recovery for investing in commercial and/or residential housing structures. This deduction (which is also available for investment in machinery and equipment) reflects a reasonable cost allowance for the wear and tear, gradual obsolence and loss of value to property due to inflation.

The current real property depreciation rules (ACRS) and the other provisions of the Economic Recovery Tax Act of 1981 (ERTA) were adopted by Congress in order to stimulate much needed private sector investment. At the time ERTA was enacted the nation's economy, and the housing industry in particular, was suffering from the deepest economic recession since the 1930s. Investment in commercial and residential development was at an all time low and housing starts and resale activity was in the midst of a 3½ year nosedive of 56 percent. Congress should well remember that it was during this cycle of very high interest rates and stifled investment that the nation lost approximately four and one half million home resale transactions with a market value of nearly one trillion dollars.

The ACRS provisions have been in effect for only an extremely brief period of time (less than 24 months, only 8 months during economic recovery). There has been limited experience with which to measure the success or failure of these depreciation provisions, especially in the area of commercial development.

Our economic forecasts show that business investment in new structures will likely remain relatively weak due to vastly different performances for investment in commercial structures, which includes office buildings, and industrial structures. Construction of commercial space, which is closely linked to the residential market, increased at an annual rate of 17 percent in real terms during the first quarter of 1983. In contrast, construction of new industrial structures declined by 31 percent during the first quarter of this year and could continue to decline through mid-1984 unless real long term interest rates, which remain at more than double their level of the past 20 years, decline much further.

We have confidence that if real interest rates drop further the investment incentives provided by ACRS will be allowed to have the very positive economic impact which Congress intended and will spur investment, increase capital formation and help to provide a sustainable economic recovery with lasting jobs creation. We understand from our contacts with members throughout the country that there are many projects waiting to begin as soon and if real rates of interest drop further. We are equally certain that any adjustment now in the existing depreciation calculations would create great investment uncertainty and would significantly discourage the desperately needed investment in industrial, commercial and residential building.

Mr. Chairman, as you noted in announcing these hearings, Congress should review tax provisions to determine if they "are still functioning as intended." We would suggest that in the case of real property depreciation, the intended result, that is increased investment, has not been given enough time especially time in the proper economic climate to be properly measured.

We would also note, Mr. Chairman, that investment in commercial and residential structures is not an unreasonably favored investment under current law. Consider Table 1 showing effective tax rates for various major components of corporate capital over selected years beginning in 1953. As demonstrated, the effective tax rate in 1983 for both commercial structures and apartment buildings substantially exceeds that of industrial equipment and public utility structures.

Note the historical trend of these effective tax rates. Consider that these tax rates on investment declined during the early 1960's and then rose steadily as inflation increased. It is only with the enactment of ACRS that tax rates on these assets now approach the rates of 1965 when commercial and residential investment and the economy were booming. Also note that while the effective tax rates on commercial structures and apartment buildings have remained relatively high over the 1953–1980 period, those rates on other assets have declined substantially over the same period (primarily because the investment tax credit is available for equipment and not for structures).

### TABLE 1.—ESTIMATED EFFECTIVE TAX RATES, CORPORATE SECTOR

| | Industrial equipment | Public utility structures | Commercial structures | Apartment buildings | Overall |
|---|---|---|---|---|---|
| 1953 | 0.58 | 0.53 | 0.50 | 0.43 | 0.55 |
| 1954 | 0.50 | 0.46 | 0.44 | 0.38 | 0.50 |
| 1961 | 0.50 | 0.46 | 0.44 | 0.38 | 0.50 |
| 1962 | 0.29 | 0.39 | 0.44 | 0.38 | 0.43 |
| 1965 | 0.09 | 0.33 | 0.40 | 0.33 | 0.36 |
| 1968 | 0.30 | 0.42 | 0.46 | 0.39 | 0.45 |
| 1970 | 0.49 | 0.45 | 0.50 | 0.39 | 0.52 |
| 1971 | 0.21 | 0.36 | 0.50 | 0.39 | 0.43 |
| 1974 | 0.25 | 0.38 | 0.50 | 0.39 | 0.44 |
| 1975 | 0.09 | 0.29 | 0.50 | 0.39 | 0.41 |
| 1980 | 0.16 | 0.31 | 0.50 | 0.39 | 0.43 |
| 1981 | 0.04 | 0.27 | 0.39 | 0.33 | 0.38 |
| (1985)[1] | −0.07 | 0.25 | 0.39 | 0.33 | 0.36 |
| (1986)[1] | −0.26 | 0.18 | 0.39 | 0.33 | 0.33 |
| 1983 | 0.15 | 0.29 | 0.39 | 0.33 | 0.39 |

[1] Effects of the 1981 provisions which were scheduled but repealed by the 1982 Act.

Source: Adapted from J. Grevelle, Effects of the Accelerated Cost System by Asset, Congressional Research Service, Economics Division, Aug. 31, 1981.

A further depreciation adjustment now, expanding the disincentive to real estate investment demonstrated by Table 1, can be expected to delay, weaken, or possibly abort the economic recovery now just beginning.

For example, consider Table 2. This table shows the dramatic affect of applying full recapture of depreciation to rental residential buildings. Such a change would clearly disrupt investment decisions on this important sector of the economy—a dramatic reversal in tax policy in less than two years.

### TABLE 2.—IMPACT OF ALTERNATIVE RECAPTURE SCHEMES ON INTERNAL RATE OF RETURN ON INVESTMENT IN TYPICAL NEW RENTAL RESIDENTIAL BUILDING

| Recapture scheme | | | Net change from current law in internal rate of return (percent per year)—holding period | | |
|---|---|---|---|---|---|
| Depreciation rate | Life | Recapture | 5 years | 10 years | 15 years |
| S.L. | 15 years (current law) | Section 1250 | | | |
| Do | 15 years | Section 1245 | −3.3 | −1.7 | −0.9 |
| 175 percent | 15 years (current law) | Section 1250 | | | |
| Do | 15 years | Section 1245 | −3.4 | −1.7 | −0.9 |

Source: National Association of Realtors®.

The tax provisions regarding taxable gain on home sales and rehabilitation tax credits provide equally compelling public policy justifications.

Current law provides that capital gains taxes on home sales may be deferred so long as the seller buys another home within 2 years costing at least as much as the home sold. Additionally, the first $125,000 of capital gains on a home sold by a taxpayer age 55 or older is excluded from taxation. The deferral or exclusion of capital gains taxation on home sales is clearly justified because the gains generally reflect simply a rise in housing prices due to inflation. An immediate tax on this gain would greatly reduce the ability of a seller to replace the home sold and would impose an undue hardship on those individuals selling their homes for personal, uncontrollable reasons; for instance, to relocate because of employment opportunities.

The age 55 exclusion is particularly wise public policy designed to ease the heavy tax burden which could result to older Americans when they decide to sell a lifelong residence to become renters or to move to a less costly residence. Without this provision, many older Americans would stay in housing which they no longer want or need—thus reducing the available housing stock for others.

The National Association of Realtors ®, and presumably the millions of homeowners who may someday be required to relocate, support continuation of the existing provisions relating to the capital gains taxation on home sales.

These provisions help to assure a strong housing market and, as a consequence, a healthy economy. Assuming continuation of current law, we expect about 2.7 million existing units to change hands in 1983—38 percent above the 1982 level. Resales should continue at a healthy pace during 1984 providing the foundation for lasting economic recovery.

Tax credits for the rehabilitation of older buildings and historic structures were enacted as part of Congress' strong desire to encourage renovation of existing premises rather than simly abandoning older buildings for new structures. These credits are an important part of renovating and preserving this nation's cities and historic structures. We know of many renovation projects, for instance in the cities of Nashville, Tennessee or Newport News, Virginia, which simply could not have been done without these tax credits. The National Association of Realtors® would hope that these rehabilitation tax credits continue to be available; especially in light of the Administration's interest in revitalizing cities through the use of "enterprise zones."

The National Association of Realtors ® is additionally concerned with a home investment tax incentive provided to savings and loan associations. We are opposed to the efforts of the savings and loan industry to reduce their investment in home mortgage loans. Current law allows these institutions a 40 percent tax reduction if 82 percent of their assets are invested in home mortgage loans. There is an effort to reduce this to 72 percent; similar to that required of mutual savings banks. We would oppose such a reduction especially since the ties between savings and loan associations and the housing industry have been relaxed to such a great extent already. With housing showing the way to economic recovery now is certainly not the time to allow a reduction in the much needed reliable source of mortgage capital.

## CONCLUSION

Housing investment and real estate development require long term certainty in investment strategy. We urge Congress to continue the existing tax provisions benefiting the real estate industry. Constant tax policy changes or adjustments create uncertainty which will stiffle investment and very possibly upset the economic recovery now underway.

ATTACHMENT NO. 1.—GROSS NATIONAL PRODUCT GENERATED BY THE AVERAGE PRICED SINGLE-FAMILY RESALE AND THE CONSTRUCTION AND SALE OF THE AVERAGE-PRICED NEW SINGLE-FAMILY HOME: 1983

| | Resale | New |
|---|---|---|
| Average selling price | $80,700 | $87,100 |
| Expenditure category: | | |
| Construction | | 53,051 |
| Expenditures before resales | 807 | |
| Expenditures at time of sale | 7,663 | 4,705 |
| Expenditures after the sale | 1,614 | 1,742 |
| Lenders' investment of cost of funds | 468 | 1,281 |
| Mortgage insurers' income | 11 | 39 |
| Subtotal | 10,563 | 60,818 |

ATTACHMENT NO. 1.—GROSS NATIONAL PRODUCT GENERATED BY THE AVERAGE PRICED SINGLE-FAMILY RESALE AND THE CONSTRUCTION AND SALE OF THE AVERAGE-PRICED NEW SINGLE-FAMILY HOME: 1983—Continued

| | Resale | New |
|---|---|---|
| Multiplier effects | 5,282 | 30,409 |
| Total | 15,845 | 91,227 |

Source: National Association of Realtors®.

ATTACHMENT NO. 2.—OUTPUT AND EMPLOYMENT OF THE REAL ESTATE INDUSTRY: 1983

GNP [in billions]

| | Direct | Indirect | Total | Full-time jobs (thousands) |
|---|---|---|---|---|
| Single-family resales | $28.7 | $14.3 | $43.0 | 850 |
| Single-family starts | 64.0 | 32.0 | 96.0 | 1,920 |
| Maintenance repairs and construction improvements | 55.0 | 27.5 | 82.5 | 1,650 |
| Multifamily starts | 23.6 | 11.8 | 35.4 | 710 |
| Commercial development | 38.0 | 19.0 | 57.0 | 1,140 |
| Industrial development | 13.5 | 6.8 | 20.3 | 405 |
| Other private construction | 11.7 | 5.8 | 17.5 | 350 |
| Total | | | 351.7 (10.7 percent of total GNP) | 7,025 (6.9 percent of total employment) |

Source: National Association of Realtors®.

## STATEMENT OF DAVID SMITH, VICE PRESIDENT AND SECRETARY, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, D.C.

Mr. SMITH. Mr. Chairman and members of the committee:

My name is David Smith. I am the vice president and secretary of the National Association of Home Builders. I am testifying on behalf of more than 111,000 members of the NAHB.

The push for additional revenue, the focus of these hearings, is generated from the pressure of high budget deficits. Budget deficits have both a spending and a revenue component. The NAHB is disappointed that Congress has not made significant progress in curtailing entitlement programs. NAHB is concerned that future revenue-raising efforts may prove to be counterproductive. In the short term, such efforts could jeopardize the current economic recovery; in the long term, changes could further increase the tax burden on real estate investment compared to other types of investments, thereby further heightening the current relative tax disadvantage for real estate. Existing tax provisions directed toward housing are necessary as an incentive for adequate production of housing. At a minimum, exiting incentives should be retained, and there is strong justification that they should be increased:

First, the NAHB estimates that a housing shortfall of 1.3 to 1.5 million units cumulatively for 1981 through 1983.

Second, a strong housing industry is an essential element in a sustained economic recovery.

Third, the popular view that housing—owner-occupied and rental—is now and has been a favored tax investment causing a misallocation of capital is seriously flawed.

I would urge the committee to study closely the written testimony dealing with the housing shortfall and its implication on housing for the overall economic recovery, looking more closely at the question of tax fairness.

The NAHB urges the committee to retain current tax incentives for housing. As part of your statement for further study, there is a booklet "Is Housing Using Too Much Capital?" which refutes the popular perception that housing is taking too much capital.

For owner-occupied housing, the mortgage interest deduction has a high level of popular appeal. This incentive, coupled with the deduction for real estate taxes, the deferral on capital gains for the sale of a home, and the one-time exclusion for capital gains for those over 55 has made home ownership possible for millions of Americans, but the incentive for home ownership far exceeds tax considerations. From a tax point of view, changes in the tax law have diminished the attractiveness of home ownership relative to other types of investments. These changes include marginal rate reductions and the liberalized rules for Individual Retirement Accounts. The NAHB supported increased savings incentives and views these changes as healthy; but the NAHB also believes that additional savings incentives for housing, particularly an Individual Housing Account as provided for in Senate bill 1435, are needed.

Regarding rental housing, it is important that the Committee not change the current tax rules. These rules provide an efficient mechanism for bringing capital into the rental housing. This is the case even though, relative to other types of assets, the ACRS change in 1981 placed a relatively high tax burden on tax structures which do not have the advantage of the investment tax credit.

The committee should be aware that prior to 1981 component depreciation provided a significant tax writeoff. The changes in 1981 for new property were not the bonanza that many believe; in fact, the NAHB study as shown in appendix 4 indicates that component depreciation provided a better return than ACRS. NAHB would therefore urge the committee to retain the present recovery allowance for structures. A change in depreciation allowances would only drive capital away from real estate, which is a much more risky investment than other types of investments.

In conclusion, the NAHB would urge the committee to proceed slowly and carefully as it considers drastic changes in the current tax law.

We appreciate the opportunity to present our views concerning the tax issue.

Senator DANFORTH. Thank you, sir.

[The prepared statement follows:]

### PREPARED STATEMENT OF THE NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. Chairman and Members of the Committee, my name is David Smith and I am Vice President and Secretary of the National Association of Home Builders (NAHB). I am testifying on behalf of the more than 111,000 members of NAHB. NAHB is a trade association of the nation's homebuilding industry.

NAHB appreciates the opportunity to present its views, along with other members of the real estate industry, on the broadening of the tax base.

While the focus of these hearings is on revenues, the push for additional sources for revenue is generated from the pressure of high budget deficits. Budget deficits have both a spending and a revenue component. With taxes increased in 1982, and the likelihood of further increases looming on the horizon, the Congress should also consider the effect of high levels of spending on the deficit. Specifically, NAHB has supported spending cuts in the growth of defense spending and entitlements. NAHB is disappointed that Congress has not made significant progress in curtailing entitlement programs. This must be addressed to provide a foundation for a sustained economic recovery.

Although NAHB has supported efforts to raise revenues through increasing the tax base, particularly the Tax Equity and Fiscal Responsibility Act of 1982, NAHB is concerned that future revenue raising efforts may prove to be counterproductive and misguided. In the short term, such efforts may create uncertainty among consumers and investors, thereby jeopardizing the current economic recovery. In the long term, changes could further increase the tax burden on real estate investment compared to other types of investments, thereby further heightening the current relative tax disadvantage for real estate.

Specifically, existing tax provisions directed towards housing—both owner occupied and investment rental housing—are necessary as an incentive for production of housing. At a minimum, existing incentives should be retained, and there is strong justification that they be increased.

The importance of retaining existing tax incentive can be viewed from several perspectives.

First, NAHB estimates a housing shortfall of 1.3 to 1.5 million units cumulatively for the first three years of the 1980s (1981–83). The shortfall is a result of the underproduction of new housing units during the past several depression years of the housing industry. Housing production has been inadequate to meet our demographic needs. Tax increases falling directly on housing would only decrease the supply of available housing units and reduce opportunities for Americans for livable and affordable housing.

Second, housing is a crucial component of the overall health of the general economy. Housing is in the forefront of leading the current economic recovery. A strong housing industry is an essential ingredient in a sustained economic recovery. The possibilities of tax increases—on homeowners through changes in the mortgage interest deduction or other provisions affecting homeowners or on investors through changes in the tax rules governing real estate investment such as ACRS, "at-risk", the rehabilitation tax credit, and depreciation recapture—create considerable consumer and investment uncertainty. This translates into buyer reluctance to purchase a home or investor reluctance to commit to investment in relatively risky real estate developments. Therefore, uncertainty about future tax provisions, which arise from the seemingly continuous interest in Washington in changing the tax rules, has a detrimental effect upon the housing industry which translates into less growth in the economy.

Third, the popular view that housing—owner-occupied and rental—is now and has been a tax favored investment, causing a misallocation of capital, is seriously flawed. In reality, tax incentives directed towards housing have gradually been reduced relative to incentives for other types of investments. High inflation, along with the lag in long-term interest rates, created a period when housing—particularly owner-occupied housing—was a favored investment. But, tax considerations were only one among several reasons which encouraged investment in housing. The high tax burden on housing oriented investments, compared to other assets, means that tax increases directed towards housing would push investment away from housing, when for strong policy reasons, such investment is needed.

### I. HOUSING SHORTFALL

An important consideration when looking at tax incentives affecting housing is the present state of the housing industry, its future prospects, and projected future housing needs. The immediate situation points towards a continuing housing recovery, despite recent interest rate increases. However, the housing recovery is fragile and could turn downward.

Some important indicators are:

(1) The seasonal rate for building permits increased 71 percent to 1,622,000 in May, 1983 from the May, 1982 rate of 951,000. It was up 6 percent from the April, 1983 rate of 1,536,000.

(2) The May, 1983 seasonally adjusted starts rate for single-family and multi-family was 1,791,000, up 74.2 percent from one year ago and up 19.1 percent from the April, 1983 rate of 1,504,000. Actual starts for the first 5 months of 1983 were 635,200, up 75.2 percent from the same period one year ago (362,000) but down 18.2 percent from the last peak period for housing in 1978 (776,700). The NAHB Economics Department estimates housing starts at 1,558,000.

(3) New home sales for the first 4 months of 1983 (199,000) are up 60 percent from the same period one year ago (125,000). The April, 1983, rate of 573,000 was 68 percent above the rate one year ago.

(4) New unsold inventory is generally declining with a slight increase from March to April. In April, 1983, inventory stood at 270,000 or 5.7 months of inventory at current sales rates.

(5) Construction unemployment still at 20.4 percent in May 1983, representing over 1.1 million people out of work. This, however, has dropped from a peak of 22.3 percent in October, 1982.

The immediate implications of this data is that the prospects for a continued economic recovery in housing are good. However, the question emerges—With interest rates going back up, can the recovery be sustained? Presently, there is no clear answer. If the recovery does not continue, a long-term shortfall in available housing would be one result of the downturn.

A look at past economic cycles provides a broader view of past housing trends and anticipated needs. The 1982–83 housing depression was extremely severe. The housing industry operated at its lowest level of production since 1946.

Starts in 1982 ended up at 1.07 million, about 46 percent below the peak of the previous cycle in 1978. New home sales were at their lowest level since the Census Bureau began its survey in 1963. Construction unemployment averaged 20 percent, the highest level since the Bureau of Labor Statistics began its monthly unemployment survey in the late 1940's. The housing industry (with the exception of some builders in Texas and other isolated areas) is very happy that 1982 has ended.

The cyclical nature of housing production coupled with the deeper housing recessions indicate a mounting shortage in available housing units, especially rental units for lower households.

Future demographic trends demonstrate the magnitude of the anticipated housing shortfall, which the recent severe depression has exacerbated. The Joint Center for Urban Studies at Harvard and MIT has projected household formations in the 1980s to be between 1.3 and 1.5 million annually.

The shortfall will be especially acute in the area of rental housing. It should be noted that the housing start numbers include both single and multi-family housing starts. Therefore, depression years with low housing starts affect not only single-family homes for sale but available rental housing. In the future, new rental construction is not anticipated to keep pace with the elimination of existing housing stock due to age and decay and the increased demand for rental housing. NAHB estimates that multifamily housing construction will average approximately 500,000 new starts over the next 10 years. The annual shortfall between supply and demand for rental units during recent years has been estimated at 75,000–100,000 units annually. These trends occur at a time when government-assisted housing construction has been virtually eliminated.

The anticipated housing shortage does not necessarily mean a return to the robust housing market of the late 1970's. Despite the reality of increased demand, builders are more cautious than in the past. The prospects of the return of higher interest rates has made new homebuilding a much more risky venture than in the past. Interest rates will not return to the levels which existed in the 1970's. This will moderate the demand for owner-occupied residences and increase pressures on rental housing.

From a policy perspective, this future scenario creates continuing pressure to retain existing tax incentives directed towards housing and to add to targeted incentives directed towards savings, such as an Individual Housing Account. Therefore, if we are to provide even the minimum level of housing needed, existing tax incentives should not be reduced. If the incentives are adversely affected, the projected shortfall would only increase.

## II. HOUSING AND THE ECONOMIC RECOVERY

A second important consideration when examining tax incentives directed towards housing is the central role which housing plays in the overall health of the economy. Although it is difficult to trace precisely throughout the economy the effect of each new housing start, it is fair to say that following each of the Nation's post-war recessions, housing has led the way to recovery.

There is an enormous ripple effect associated with housing. A housing upturn has created jobs, improved consumer and investor confidence, and stimulated activity throughout the economy. NAHB estimates that each 100,000 new single-family homes provide 176,000 worker-years of employment to construct. When taking into account the financial, legal and other services involved in selling the units as well as the spinoff purchases of goods and services generated by the home sales, an estimated 280,000 additional worker-years of labor are created throughout the economy.

The current recovery has relied to a large extent upon housing as the engine for recovery. Changes in the tax law affecting housing are bound to have implications as far as a sustained economic recovery is concerned.

What is needed is certainty. Constant changes in the tax law and in regulations make business and consumer planning difficult. Uncertainty increases investor and consumer costs.

An example of the effect of uncertainty in the marketplace is the discussion surrounding the mortgage interest deduction. Late in 1982 and early 1983, Treasury Secretary Donald Regan made certain statements about eliminating the mortgage interest deduction for second homes. Recently, the Democratic Study Group has looked at proposals to cap the mortgage interest deduction at $10,000. The effect of such statements, even though they may have only a remote possibility of enactment, is to create uncertainty in the consuming public about the future. This translates into hesitancy on the part of homebuilders to commit new funds for new development and hesitancy on the part of consumers to commit to a major investment decision—the purchase of a home.

Although difficult to measure, the need for tax certainty, in both business and individual planning, is something this Committee should consider carefully when it initiates hearings and legislation affecting many taxpayers. Obviously, budget deficits must be dealt with and are a pressing national problem. But NAHB urges this Committee to move slowly and cautiously in its consideration of revenue raising proposals, keeping in mind the potential effect of changes during this crucial stage of the economic recovery.

## III. TAX FAIRNESS

A popular misconception has developed that housing, both owner-occupied and rental housing investment, has absorbed too much of our nation's capital. A popular belief is that tax incentives for housing have been a major cause of this so-called "misdirection" of capital. The shortfall in housing supply as compared to new family formations and future estimated demand for housing should alone act as a refutation of this argument. NAHB has produced a detailed response which addresses this issue and is attached to my statement.

This view needs to be looked at more closely in the context of tax incentives for housing as compared to tax incentives for other forms of investments. In actuality, housing—single-family and rental—may be at a tax disadvantage relative to other types of investments. There is a disparity between the taxation of housing in relation to other investments, with a higher tax burden on housing. Future tax increases directed towards housing would only heighten the disparity and push needed investments elsewhere.

Before examining this view in greater detail, a note of caution should be sounded about the tax expenditure concept. It is based upon the view, as stated in the tax expenditure analysis by the Joint Committee on Taxation for 1983, that "Tax Expenditures . . . are analogous to . . . direct expenditures . . . which are available as entitlements to individuals and corporations who meet the criteria established for the programs." (Page 2) The idea that foregone tax revenues are analogous to direct spending may be useful as an analytical concept. However, what is and what is not a tax expenditure is often an arbitrary decision. It depends upon an initial judgement as to what is needed to produce the ideal tax law. What is and is not a tax expenditure will, therefore, depend upon the initial construct of a "model" tax code.

A concrete example of the arbitrariness of labeling various code provisions as a "tax expenditure" is the differing treatment which accelerated cost recovery (ACRS) is given in the Joint Committee analysis of tax expendites and in the Administration's tax expenditure analysis. (Special analysis G of the Budget). The Administration excludes depreciation for structures from its tax expenditures analysis. The Joint Committee includes depreciation in excess of straight line in its analysis.

Therefore, as the Committee looks at various methods of broadening the tax base, care should be taken to realize that in actuality what the Committee is going is raising taxes on various groups of taxpayers. In so doing, it is changing a whole series of relationships among various types of investments. The effect of such changes on the general economy must be carefully considered.

Looking first at owner-occupied housing, there are several important tax incentives which have been listed. These include the mortgage interest deduction, the deduction of real estate taxes, the deferral of capital gains on the sale of a home, and the one-time exclusion for capital gains up to $125,000 on the sale of a personal residence for those over 55. Of these incentives, the mortgage interest deduction is the most popular and involves the largest revenue loss.

The mortgage interest deduction, coupled with the deduction of property tax, probably has a higher level of appeal to middle-class Americans than any other tax deduction. It makes the ownership of a home affordable for many Americans. Take, for example, a married couple with two children filing a joint return. Using the tax rates effective July 1, 1983, and assuming a family income of $35,000 per year, the mortgage interest deduction helps this family qualify for a $70,000 house. Without the mortgage interest deduction, the same family could qualify for only a $53,000 home. With the average price of a new home in the $70,000 range, the mortgage interest deduction becomes an important element in permitting ownership of a home. The details of the example are provided in Appendix II. While the mortgage interest deduction makes housing affordable, the view that it overly subsidizes housing at the expense of other investments, needs to be reviewed more closely.

Double digit inflation, high marginal tax rates, and fixed rate mortgages at a level below the inflation rate produced a combination of factors which made housing a favored investment in the 1970s. High marginal tax rates, which placed many middle-income taxpayers in high tax brackets, made the mortgage interest deduction extremely valuable for most middle-income families. In these circumstances, housing, with a high loan-to-value ratio, became a popular investment.

But the economic circumstances which made owner-occupied housing attractive from an investment point of view have reversed. Inflation-induced increases in housing prices have moderated substantially.

In March, 1983, the median price of new homes sold was $73,500, up $6,300 from the median price of $67,200 a year earlier. The median price of new homes sold in 1982 was $69,300—only a .6 percent increase over 1981, when the median price averaged $68,900. Actual housing costs, however, were even lower than those registered by new home prices, because many builders bought down mortgages and used other methods of creative financing to sell off inventories. Prices over the past two years have been relatively flat when compared with prices during the inflationary 1970s.

From a tax point of view, marginal rate reductions have decreased the value of the mortgage interest deduction, as well as other itemized deductions, as more and more taxpayers are dropped into lower marginal tax brackets. Increases in the standard deduction also have eroded the tax advantages associated with the mortgage interest deduction and housing investment.

Finally, incentives for alternative investments, particularly individual retirement accounts and other forms of savings have helped to reorder priorities towards savings.

This shift is a direct result of tax changes which were put in place in 1981. As the Economic Report of the President for 1982 noted: The sizable reduction in tax rates on capital income mean that real after tax returns on household savings will be substantially higher than they have been in the recent past. As a result, the implicit price of consumer durables has risen and a long run shift in demand away from housing, automobiles, and other consumer durables may result. (Page 126)

The movement in tax incentives away from housing is confirmed in a study dated October 25, 1982, by the Congressional Research Service. The study, *Tax Subsidies to Housing, 1953–83* indicates that tax subsidies for housing, both owner-occupied and rental investment housing, have declined over time as compared to tax subsidies for other types of assets. The study notes "the spread between the return on business assets and the return on owner-occupied housing has diminished and in some cases disappeared. One can no longer argue unambiguously that owner-occupied housing receives a tax subsidy relative to business capital." (Page 22)

NAHB views the direction of tax changes towards more savings and investment as a healthy and necessary change. The point is not that the changes should have been made, but only that the changes reduce the tax incentive associated with a home purchase compared to other types of investments.

The social and political stability which homeownership promotes make it a top national priority. An important proposal which would assist in the purchase of a home is the establishment of an Individual Housing Account as provided in S. 1435. Enactment of S. 1435 is a major NAHB legislative priority. Senators Wallop, Dole, Boren, Pryor, Symms, Grassley, Durenberger, Heinz, Danforth and other have introduced S. 1435. It accomplishes the objectives of greater savings while increasing opportunities for the purchase of a home.

Regarding rental housing, tax incentives, including ACRS depreciation, "at-risk" provisions, and recapture rules for rental housing are a major means of providing for investment in rental housing projects. Changes in the current tax rules would severely disadvantage investment in rental housing as opposed to other types of investment alternatives. The history of recent tax legislation affecting residential structures has been a progressive diminution of the tax benefits associated with this type of investment. The requirement that construction period interest and taxes (IRC Section 189) be capitalized was introduced in 1976. No other industry other than real estate construction is required to capitalize interest. Residential real estate also does not have the advantage of the investment tax credit, except for the rehabilitation of historic structures. In addition, the alternative minimum tax often affects capital gains associated with real estate investments more than it affects investments in other types of assets, particularly corporate equities or bonds.

The ACRS recovery allowance for structures, adopted in 1981, should not be revised to reduce current depreciation allowances.

From an investment point of view, rental housing has often not been attractive. Intensive management is necessary to both maintain rental housing and to assure a steady income stream. Cost of maintenance of rental property have increased considerably in recent years. In addition, income generated from rental property is lower than for other types of property.

Residential rentals do not generally carry CPI inflation increases, and the income of residents can only support a certain level of rent. Therefore, market rents generally do not create an income stream which is competitive with other types of investments. In addition, rent control in many jurisdictions has kept rents at below market levels.

As a result, residential housing needs to retain current depreciation allowances to be competitive with other types of investments. A reduction in present depreciation allowances would only drive capital away from residential housing at a time when more, not less, capital is needed.

NAHB supported the 1981 ACRS depreciation changes because of their certainty and simplicity. It is, however, a misconception to believe that the changes, in terms of new residential construction, significantly increased depreciation write-offs. In fact, component depreciation plus the ability to use 200 percent declining balance often created a more advantageous depreciaton situation for new housing than the situation after ACRS. The table in Appendix IV analyzes component depreciation and ACRS. The table in Appendix IV analyzes component depreciation and ACRS. As the table demonstrates, component depreciation provided larger total write-offs over six years than are allowed under ACRS. The tax savings as well as interest on the tax savings amounted to a substantial sum.

Possible changes in the current tax rules associated with depreciation allowances for structures would bring uncertainty into the market place again, thereby diminishing the potential for future economic growth in this important sector of the economy.

The ACRS changes benefitted other types of assets, particularly equipment, much more than real estate. The effective tax on structures, was relatively unchanged both before and after 1981. This result is confirmed in several places. First, the economic report of the president, 1982, comments: . . . ACRS does not treat all types of business investments equally. Although favorable to all new investment, ACRS is relatively more favorable to investment in equipment. As a consequence, industries for which short-lived equipment represent a large fraction of their total capital will face lower effective tax rates than industries with a low equipment-intensive capital structure. (Page 124)

The relative bias of current tax rules toward equipment as opposed to apartment buildings is underscored in a Library of Congress study in 1981 entitled *Effects of the Accelerated Cost Recovery System by Asset Type*. The study notes: . . . there may well be a shift in the composition of capital towards business equipment and away from structures particularly away from residential structures. The relative (and perhaps absolute) size of the housing stock could fall, not only because of the effects on rental housing but also because high interest rates will make owner-occupied housing less attractive and because there are no offsetting tax benefits.

Therefore, as the Committee looks at base broadening approaches, the relatively heavy tax burden on rental housing should be considered. Rather than increasing the tax burden by changing ACRS, the Committee should look at other revenues for broadening the tax base.

Another aspect of the ACRS that has generated criticism is that used property is treated the same as new property; both are equally eligible for the 15-year ACRS write-off. However, the ACRS is available for used property only if the persons acquiring the property did not own it prior to 1981, the year the ACRS rules became effective. Thus, while sales of existing residential property are possible, these involve a new set of purchasers and free up the capital of the former owners that has been locked up in such property. This freeing up of capital is a positive rather than negative result since the capital can be channeled into new investment. Moreover, the treasury benefits from the capital gains tax that must be paid as a result of the resyndication.

Concern has also been expressed that the ACRS may be used for property received in a tax-deferred exchange qualifying under IRC § 1031. This situation, however, is covered by the comprehensive rules against "churning" provided in IRC § 168(e)(4). These rules deny ACRS depreciation for property received in exchange for pre-1981 property in a tax-deferred exchange unless additional debt or cash is made part of the transaction. Even then, ACRS is available only to the extent of the new debt or cash.

Finally, in looking at broadening of the tax base, the idea of the flat rate tax or variations such as the Bradley/Gephardt proposal come to mind. NAHB urges that the implications of such a flat rate tax or other comprehensive changes be carefully considered. NAHB is now conducting a thorough study of the flat rate tax for presentation to its members at its next annual convention in January, 1984.

### IV. SUMMARY

NAHB would urge this Committee to proceed slowly and carefully as it considers drastic changes in the current tax law. In seeking to work towards a balanced budget, the Congress should look at spending restraint as the first approach for achieving a balanced budget.

With the budget resolution mandating substantial tax increases, as this Committee looks at tax expenditures and at future tax legislation, it should keep in mind the implications of various tax proposals upon housing—both owner-occupied housing and rental units.

The recent housing depression has created a shortfall in available housing units, especially rental units for low and moderate income families. Changes in the tax code, which would increase the tax burden on housing, would inevitably heighten the housing shortfall.

The crucial role of housing as the engine of the present economic recovery also needs to be considered. Uncertainty about the future, particularly the tax future, has a dampening effect upon investment decisions. Discussion of dramatic changes in the tax law affecting housing would lead to a slower recovery.

Finally, it is a misconception to view housing as being favored under the tax code. The tax benefits for owner-occupied housing have diminished through changes in the economic environment and as tax incentives for other types of investment have increased. With regard to business assets, structures have a heavier tax burden than other types of assets. Changes in the depreciation life for structures would only increase this tax burden and drive investment away from needed rental housing.

We appreciate the opportunity to present our views concerning important tax issues. I would be pleased to answer any questions you may have.

---

## APPENDIX I

### BACKGROUND: CURRENT HOUSING PRODUCTION AND PAST CYCLES

A comparison with past housing cycles shows that the current downturn was much more severe than past recessions. The latest housing recession was the longest running and the most devastating of the seven the industry has suffered since World War II. Total housing starts for 1981 were 1,100,300—the lowest annual production since 1946. Starts in 1982 finished slightly below the 1981 level.

1983 is forecast as a recovery year. The housing recovery will be strongest in the Sunbelt and less convincing in other areas of the Northeast and Midwest, whose main-line industries have been especially hard hit by the recession.

The recovery will be significantly slower than those that preceded it because: 1) it will take time for suppliers of building materials to shift back to higher levels of production; 2) the general economy will not gain as quickly as housing, most likely leaving unemployment above 10 percent unitl mid-year; and 3) mortgage interest rates, while significantly lower than they were during the recession, will, because of structural changes in the savings industry, remain relatively high by historical standards.

### SEVEN HOUSING CYCLES SINCE WORLD WAR II

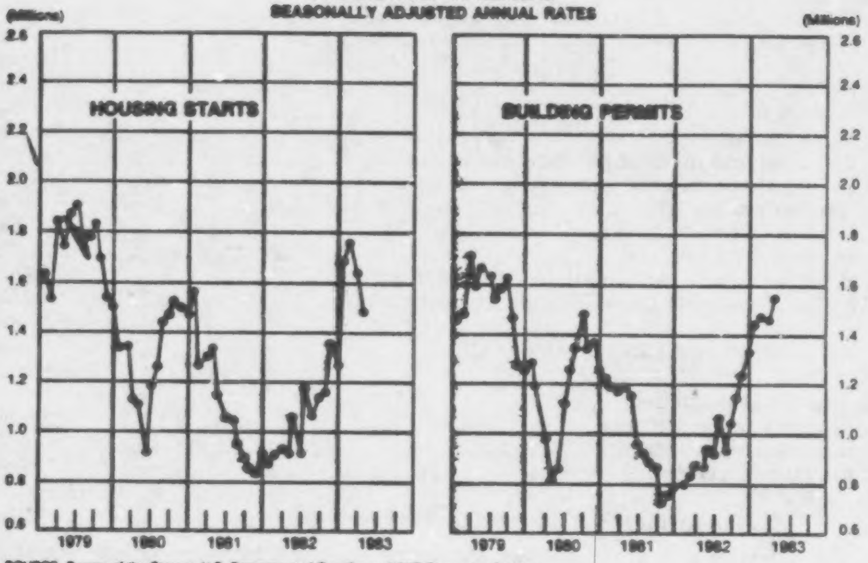
| Period | No. of mo., between high and low | Number of housing starts (in thousands) | | | Percent change |
|---|---|---|---|---|---|
| | | High | Low | Difference | |
| August 1950–July 1951 | 11 | 1,889 | 1,154 | 735 | −38.9 |
| December 1954–March 1957 | 27 | 1,703 | 1,068 | 635 | −37.3 |
| December 1958–December 1960 | 24 | 1,604 | 1,041 | 563 | −35.1 |
| December 1965–October 1966 | 10 | 1,656 | 843 | 813 | −49.1 |
| January 1969–January 1970 | 12 | 1,769 | 1,108 | 661 | −37.4 |
| January 1973–February 1975 | 25 | 2,481 | 904 | 1,577 | −63.6 |
| November 1978–October 1981 | 36 | 2,107 | 854 | 1,253 | −59.5 |

On a ten-year basis, between 1971 and 1981, total private and public housing starts ranged from a high of almost 2.4 million units in 1972 to a low of just over 1.1 million units in 1981. A new annual low for the period was set in 1982—1.07 million units.

| Year | Price | Year | Price |
|---|---|---|---|
| 1971 | 2,084,500 | 1977 | 2,001,700 |
| 1972 | 2,378,500 | 1978 | 2,036,100 |
| 1973 | 2,057,500 | 1979 | 1,760,000 |
| 1974 | 1,352,500 | 1980 | 1,312,600 |
| 1975 | 1,171,300 | 1981 | 1,100,300 |
| 1976 | 1,547,600 | 1982 | 1,072,000 |

APPENDIX I Con't

HOUSING TRENDS
SEASONALLY ADJUSTED ANNUAL RATES



SOURCE: Bureau of the Census, U.S. Department of Commerce, NAHB Economics Division

## APPENDIX II

### MORTGAGE INTEREST DEDUCTION AND HOUSING AFFORDABILITY

Assume: Married couple filing joint return. $3,400 in deductions other than mortgage interest. Adjusted gross family income of $35,000 per year. Tax rates effective July 1, 1983.

| | |
|---|---|
| **Mortgage interest deduction:** | |
| Term (years) | 30 |
| Interest rate (percent) | 12 |
| Price | $70,000 |
| Downpayment | $7,000 |
| Mortgage amount | $63,000 |
| Principal and interest per month | $648 |
| Principal and interest per year | $7,776 |
| Interest per month | $629 |
| Interest per year | $7,548 |
| Income—Tax savings | $1,922 |
| Effective annual principal and interest payment | $5,854 |
| Effective monthly principal and interest payment | $488 |
| Effective interest rate (percent) | 8.58 |
| **Real estate tax deduction:** | |
| Property taxes per year | $1,260 |
| Income tax savings | $277 |
| Effective property tax per year | $983 |
| Total tax savings from interest and property taxes per year | $2,199 |

If one assumes principal, interest and property taxes, both deductions equal 30 percent of adjusted gross income, an income of $30,120 would be needed to qualify in the example above. Lenders calculate the interest and property tax savings into their 30 percent criterion. Hence, a family is paying only 22.7 percent of their income for principal, interest and property taxes. If there were no deduction and lenders used a 22.7 percent criterion, the family could afford a house costing only $53,000.

---

## APPENDIX III

### NEW HOME PRICES: 1972 TO 1982

From 1972 to 1982, prices rose about 151 percent, from $27,600 to $69,300.

| Year | Price | Year | Price |
|---|---|---|---|
| 1972 | 27,600 | 1978 | 55,700 |
| 1973 | 32,500 | 1979 | 62,900 |
| 1974 | 35,900 | 1980 | 64,500 |
| 1975 | 39,300 | 1981 | 68,900 |
| 1976 | 44,200 | 1982 | 69,300 |
| 1977 | 48,800 | | |

---

## APPENDIX IV

### COMPONENT DEPRECIATION VERSUS ACRS: NEW CONSTRUCTION

The following assumptions are made in the example:

(1) The owner is in a 50 percent tax bracket.
(2) The owner changes to straight line depreciation.
(3) The building was completed and placed in service on January 1, 1983.

(4) Interest computations on tax savings are computed at 20 percent (IRS rate for 1982) for the first tax year's savings; 16 percent (IRS rate for 1983) for second year's tax savings; and 12 percent for the remaining years.

(5) Two hundred percent declining balance method is used on component depreciation.

(6) The life of the different components are taken from real estate development companies.

The analysis shows substantial benefits under component depreciation prior to 1981 as compared to ACRS. Under component depreciation, at the end of six years, there would be a tax savings of $54,553. The interest that could have been earned on this tax savings over the six year period would be $80,590. Therefore, efforts to reduce current depreciation allowances for structures would continue the inequitable treatment of structures, as compared with other assets, which was created in 1981.

## NAHB EXAMPLE—SIX YEAR COMPARISON

[Component Depreciaton v. ACRS]

| | Cost | Estimated life | First year | Second year | Third year | Fourth year | Fifth year | Sixth year | Total |
|---|---|---|---|---|---|---|---|---|---|
| | | | COMPONENT METHOD PRIOR TO 1981 TAX LAW | | | | | | |
| Basic structure | $672,076 | 40 | $33,604 | $31,924 | $30,327 | $28,811 | $27,371 | $26,002 | $178,039 |
| Internal construction: | | | | | | | | | |
| Ceilings | 108.012 | 30 | 7,204 | 6,724 | 6,275 | 5,857 | 5,466 | 5,102 | 36,628 |
| Walls | 192,022 | 30 | 12,808 | 11,954 | 11,156 | 10,412 | 9,718 | 9,069 | 65,117 |
| Doors | 72,008 | 10 | 14,402 | 11,521 | 9,217 | 7,374 | 5,897 | 4,719 | 53,130 |
| Floors | 108,012 | 30 | 7,204 | 6,724 | 6,275 | 5,857 | 5,466 | 5,102 | 36,628 |
| Electrical: | | | | | | | | | |
| Wiring | 84,010 | 15 | 11,199 | 9,706 | 8,412 | 7,291 | 6,319 | 5,476 | 48,403 |
| Lamps and fixtures | 72,008 | 8 | 18,002 | 13,502 | 10,126 | 7,595 | 5,696 | 5,696 | 60,617 |
| Plumbing: | | | | | | | | | |
| Basic | 96,011 | 15 | 12,798 | 11,092 | 9,614 | 8,332 | 7,221 | 6,259 | 55,316 |
| Fixtures | 108.012 | 15 | 14,398 | 12,479 | 10,815 | 9,374 | 8,124 | 7,041 | 62,231 |
| Equipment | 60,007 | 8 | 15,002 | 11,251 | 8,439 | 6,329 | 4,747 | 4,747 | 50,515 |
| Roof | 60,007 | 10 | 12,001 | 9,601 | 7,681 | 6,145 | 4,916 | 3,933 | 44,277 |
| Air conditioning | 144,016 | 10 | 28,803 | 23,043 | 18,434 | 14,747 | 11,798 | 9,438 | 106,263 |
| Appliances | 96,011 | 3 | 64,008 | 21,333 | 10,670 | | | | 96,011 |
| Floor covering | 156,018 | 3 | 104,013 | 34,667 | 17,338 | | | | 156,018 |
| Drapes and decorating | 120,014 | 3 | 80,010 | 26,667 | 13,337 | | | | 120,014 |
| Cabinets | 72,008 | 15 | 9,599 | 8,300 | 7,196 | 6,239 | 5,409 | 4,690 | 41,433 |
| Pool | 72,008 | 8 | 18,002 | 13,502 | 10,126 | 7,595 | 5,696 | 5,696 | 60,617 |
| Outside fence | 24,003 | 5 | 9,601 | 5,761 | 3,456 | 2,593 | 2,592 | | 24,003 |
| Yard improvements | 84,010 | 10 | 16,802 | 13,442 | 10,753 | 8,603 | 6,882 | 5,506 | 61,988 |
| Total | 2,400,273 | | 489,460 | 283,193 | 209,647 | 143,154 | 123,318 | 108,476 | 1,357,248 |
| | | | ACRS METHOD AFTER 1981 TAX LAW | | | | | | |
| ACRS rate (CCH Table 1165B) (percent) | | | 12 | 10 | 9 | 8 | 7 | 6 | |
| ACRS depreciation | $2,400,273 | $15 | $288,033 | $240,027 | $216,025 | $192,022 | $168,019 | $144,016 | $1,248,142 |

| | COMPARISON | | | | | | |
|---|---|---|---|---|---|---|---|
| Difference between component and ACRS | $201,427 | $43,166 | −$6,378 | −$48,868 | $44,701 | −$35,540 | $109,106 |
| Accumulated net difference | 201,427 | 244,593 | 238,215 | 189,347 | 144,646 | 109,106 | 109,106 |
| Tax savings (50 percent tax rate) | 100,714 | 21,583 | −3,189 | −24,434 | 22,351 | −17,770 | 54,553 |
| Interest on tax savings | 20,143 | 19,568 | 14,293 | 11,361 | 8,679 | 6,546 | 80,590 |

## Housing Issues and Answers

# Is Housing Using Too Much Capital?

National Association of Home Builders

## President's Message

Behind the scenes of the most devastating housing recession since World War II, many of the nation's most prominent analysts of the American housing industry and the economy have been engaged in a sharp debate over housing's capital needs.

Some have argued that we have spent too much money on housing. They believe that government tax breaks on mortgage interest and low-cost home financing have encouraged Americans to overinvest in housing at the expense of investment in plant and equipment. Pointing to some households that made big profits on rising home values during the inflation-prone 1970s, they believe the time has come to get tough with the American homebuyer.

Our view is that by focusing on peripheral issues such as vacation homes and second mortgages, these critics have neglected the crucial housing issues confronting the nation in the 1980s. They have virtually ignored the problem of how to provide affordable shelter for record numbers of Americans who will move into the housing market during this decade. They have grossly misinterpreted what motivates families to buy homes. They have proposed curtailing capital investment in the housing sector during a period when housing investment has been at its lowest level since the 1940s. And they have downplayed the adverse impact of growing federal deficits on the recapitalization of the nation's businesses and industries.

The argument that the overconsumption of housing is responsible for our economic ills is one that cannot be substantiated, because the facts prove otherwise. We hope this report will help bring to an end the "open season" on housing that has obscured the compelling need for housing production in this decade, and at the same time, lead to a responsible debate on what needs to be done to develop a strong and effective housing policy for the 1980s.

Harry Pryde
President, NAHB

# 1

# Historical Perspective

"The housing boom of the 1970s did not result from a sustainable growth in demand for living space. Instead it was the consequence of market distortions created by misguided government policies."

—Dwight R. Lee, "Why the Housing Industry Will Not Recover," *Journal of Contemporary Studies*, Summer 1982

**Commentary**

Demand has always been the driving force in the housing market. A record 17.9 million homes were built in the 1970s. These were homes the nation needed to meet demand as record numbers of Americans reached the prime homebuying age. No other factor can adequately explain these peak housing years—*not* "speculation," *not* overproduction, *not* direct or indirect government help.

---

Since the end of World War II and through 1982, the United States built 56 million new homes, an average 1.5 million units annually. In the short run, the housing industry may have over- or under-built, depending on the overall economy, the employment situation and the level of interest rates. But in the long run, postwar housing production has responded to demand and changing demographic characteristics of the population.

There is no evidence to support the claim that too much housing has been produced in America during the past four decades. In fact, since World War II the United States has built fewer housing units per thousand population than other industrialized nations. This was true even during a peak period of U.S. production in 1977-1980, when 7.1 million housing units were started. Even then, the U.S. built fewer units per 1,000 of population than Norway, Canada, Hungary, Czechoslovakia and France.

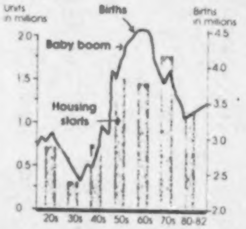
In terms of total housing stock, the U.S. also ranks well below many European nations. According to a recent U.N. study, Sweden, France, Switzerland, Denmark, West Germany and Austria have more housing units per 1,000 population than the United States.

Since the 1940s, demand has not only increased housing production levels, it has changed considerably the way homes are built. In 1940, the average floor area of a new home was 1,177 square feet, dropping to 983 square feet in 1950; increasing to 1,230 square feet in 1956, and reaching 1,655 square feet in 1978. In recent years, the size has begun to decline again, mainly in response to rising costs, but also as a result of the declining size of households.

The decade of the 1970s saw many changes in the housing market—some triggered by the high level of inflation, which was primarily due to rising oil prices; others caused by rising demand for housing as a result of the postwar baby boom. The first wave of postwar births came from 1947-1950. A second wave in the mid-1950s, peaking between 1957 and 1962, averaged per year 600,000 births higher than in the first wave.

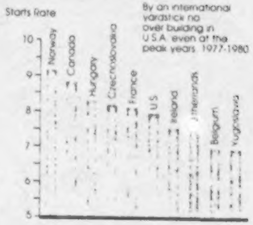
This population explosion created enormous growth in housing production during the 1970s, continuing into the 1980s. As the postwar baby boom generation moves through the housing market, the demand for new homes will remain high. By the late 1980s, however, and throughout the next two decades, demand will gradually diminish in response to the lower birth rates of the 1960s and 1970s.

**NUMBER OF BIRTHS/AVERAGE ANNUAL PRODUCTION OF NEW HOUSING UNITS**



Source: Bureau of the Census. Compiled by NAHB Economic Policy Analysis Division

**STARTS RATE PER 1,000 POPULATION IN SELECTED COUNTRIES**
(Annual averages for the period 1977-1980)



Source: United Nations Yearbook, various issues

# 2

# Housing Demand— A Closer View

**Point**

". . . The tremendous acceleration of household formation in the United States during the 1970s resulted in part from the availability of housing at low cost (in real terms); it was not a purely demographic factor to which housing markets 'had to' accommodate themselves."

—Anthony Downs, "Too Much Capital for Housing?" *Brookings*, Summer 1980

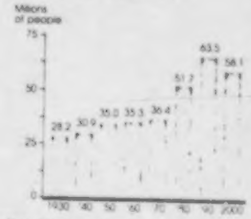
**Counterpoint**

Undeniably, the demand for housing cannot be explained entirely by demographic forces. But most of it can, especially in the 1970s and 1980s. Economic conditions can influence the personal decisions of the young to break away from parents and form separate households. But demand for housing depends mostly on changes in the number of households. And those changes are based on shifts in the population and new lifestyles.[1]

People who charge that America invested too heavily in housing during the 1970s tend to overlook the nation's unusually high household formation rate during that period. The number of Americans reaching the age of 25-39, the prime group for homebuying, increased 41.6 percent in the 1970s from the previous decade. This group will increase by an additional 13 percent during the 1980s, and will continue to support high levels of housing starts throughout the decade.

As proof that the nation has recently overbuilt its housing stock, some economists have cited statistics showing that the household formation rate exceeded the population growth rate in the 1970s.

AGE GROUP: 25–39 YEARS



Source: Department of Commerce, Bureau of the Census

The argument is erroneous because there is a gap of roughly 20 years between the time people are born and the time they begin forming households. The rates of population growth and household growth can show a wide statistical variation at any given time. It is possible to have a zero or minus population growth and yet experience an increase in the rate of household formations.

Demographic trends clearly demonstrate that the level of housing production attained during the 1970s would have been impossible without strong underlying demand from consumers who were ready to form new households. This demand was fueled by young persons reaching adulthood and choosing to establish separate households rather than remaining with their parents. It is that simple.

The increase in housing production during the 1970s corresponded with a rising demand for housing from demographic factors. The number of persons in the prime homebuying 25-39 age group increased by 15.2 million in the 1970s, compared to only 1.2 million in the 1960s. The composition of households changed dramatically as well.

Traditional husband-and-wife families accounted for only 4.2 million household formations in the 1970s, compared to 11.5 million non-traditional households formed during that time. Households headed by divorced or separated women increased by 3.4 million during the 1970s. Almost 4 million single persons living alone were added to the housing market during the decade.

By comparison, replacement demand in the 1970s played a less important role than during the 1960s, when many homes were built to replace units lost from the housing stock. Losses to the inventory from demolitions and disasters such as fires and floods averaged 380,000 units annually throughout the 1960s. In the 1973-80 period, annual housing losses declined by 110,000 units to an average of 270,000 homes.

Two factors contributed to the drop in losses. First, activity in urban renewal and interstate highway programs, which were a major cause of demolitions in the 1960s, declined in the 1970s. And second, in the 1970s rising construction costs and the movement to revitalize inner-city neighborhoods encouraged the rehabilitation of existing stock that might otherwise have been demolished.

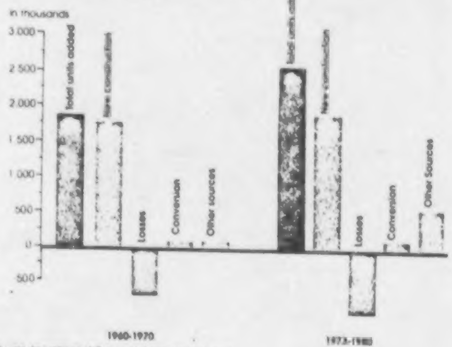
Assuming a modest 3-5 percent[2] average annual rate of real economic growth throughout the 1980s and taking into account projected household formation rates and other demand factors, new housing production should average between 1.65 and 1.75 million units a year during the 1983-89 period. During the first three years of the decade, housing production averaged only 1.16 million units a year.

In the short-run, the housing market is able to accommodate the need for shelter from a growing population without producing new homes. During the Depression and war years, when financial resources were scarce and building materials were needed for purposes other than civilian housing, Americans doubled up. But this was only a temporary solution; the growing imbalance between the demand for and the supply of new homes was eventually redressed by the massive rebuilding effort of the late 1940s and 1950s.

If they have to, Americans can double up again. But first they must be convinced that economic conditions warrant disruption of the housing market and a decline in the nation's standard of living.

So far, housing critics have been able to point to isolated cases of "overconsumption" of housing during the super-inflated economy of the 1970s. But they have failed to provide a convincing case that housing is "eating up our productive capital" or that the economy would be better served by deferring the production of housing needed by members of the postwar baby boom.

COMPONENTS OF INVENTORY CHANGE



Source: Department of Commerce, Bureau of the Census

# 3

# Housing and the Capital Markets

**Point**

"Increasingly, housing demand dominates both the economy and the capital markets. The wealth effect accruing from homrownership is spurring individuals to consume, while mortgages represent not only the latest, but also the most rapidly growing component of the capital markets."

—R. S. Salomon, Jr., "Influence of Public Policy and Risks," *Salomon Brothers Stock Research/Investment Policy*, Dec. 11, 1980

**Counterpoint**

As a share of the capital markets and as a share of the Gross National Product, the trend in housing capital consumption has been downward since the 1950s. It has taken an especially alarming tumble since 1980. The U.S. government, not housing, is the most rapidly growing user of the capital markets. Federal deficits threaten to choke off badly needed investment by business and industry, including housing. Ironically, one of the more stable growth periods occurred during the 1950s, when large amounts of capital were invested in the housing stock.

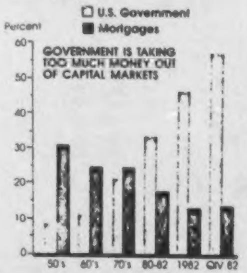
Total capital going into new housing is relatively small. New housing requires only 20 percent of the total mortgage dollars used, while 80 percent goes for financing existing home sales, refinancing and nonresidential mortgages.

Economic and monetary policy-makers have become preoccupied with the housing industry's participation in the credit markets. They contend that housing absorbs an excessive share of available credit. However, on a comparative basis, they are unable to prove their case, because statistics show otherwise.

During the 1970s, when housing production surged to record levels, residential mortgages consumed 24.8 percent of funds raised in the capital markets. That was the same amount as during the 1960s and well below the 30.9 percent share of the 1950s. Residential mortgages claimed only 17.5 percent of credit market funds from 1980-1982 and skidded further to a 13.3 percent share during the fourth quarter of 1982.

By comparison, the federal government has steadily increased its demand for loanable funds—from a 7.7 percent share in the 1950s; to 10.3 percent in the 1960s; and 20.6 percent in the 1970s. The government has taken approximately one-third of available credit during the first three years of this decade and threatens to take significantly more in succeeding years.

THE SHARE OF CREDIT MARKETS TAKEN BY U.S. GOVERNMENT AND MORTGAGES



Source: Federal Reserve Board. Compiled by NAHB Economics, Policy Analysis Division

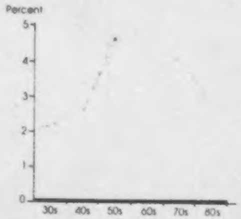
The federal government cornered a whopping 57 percent share of the nation's credit during the final quarter of 1982, leaving little question who's the fat man in the financial markets. Unless Congress and the Administration find the means to bring soaring annual deficits of $200 billion under control, the federal government threatens to crowd out the entire business investment sector—not just housing.

Gross National Product statistics also prove invalid the contention that the use of capital by the residential sector has been a drag on the economy. They demonstrate that housing's share of total U.S. economic output has fallen today to the lowest levels since the 1940s.

From 1946-1979, new residential investment as a percentage of GNP in current dollars hovered around a mean of 4.8 percent. Since 1979, the share has declined to 3.5 percent. The evidence is even more compelling in constant dollars, which show that housing's share of GNP has been falling continuously since the 1950s.

But the argument does not end here. In defense of his claim that too much capital has been flowing into the housing sector, Brookings analyst Anthony Downs has cited statistics showing that total mortgage financing has been rising sharply in comparison to the total cost of new housing produced.

NEW RESIDENTIAL CONSTRUCTION AS A PERCENT OF GNP
(by decades)



Source: Department of Commerce. Bureau of Economic Analysis

Downs believes that excessive amounts of mortgage capital have been used to finance existing homes, thereby inflating the value of the existing housing stock. He also argues that inflated home equities have been used by consumers to make purchases not directly related to the production of housing.

In reality, there appears to be little causal relationship between the sales of existing homes and inflation in the housing sector. Increases in the cost of existing homes have generally followed increases in new home prices. Since the 1970s, inflation in the housing sector has been largely a function of external pressures such as rises in the cost of oil and rising demographic demand.

Arthur Solomon, executive vice president and chief financial officer of the Federal National Mortgage Association, has addressed Downs' argument this way:

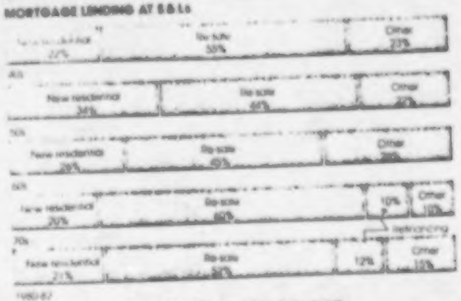
"With respect to the ratio of total mortgage financing to the cost of new housing put-in-place, the explanation seems straightforward—this ratio has been increasing because a larger share of total mortgage financing has been devoted to the sale of existing homes and to home improvements rather than to new construction in recent years. Second, since the stock of existing homes continues to grow in relation to the amount of dwelling units added through new construction, the ratio of total mortgage financing to the cost of new housing automatically increases. To a lesser extent, the increase in the ratio reflects declining down payment requirements for new homes."[4]

Citing aggregate amounts of capital going into the housing sector, as many critics have done, is misleading in any case, because the housing market is composed not only of new housing, but existing homes, remodeling and refinancing as well.

A break-down of the housing market shows that the resale of existing homes accounts for the largest portion of the mortgage market financed by savings and loans. Resales accounted for 44 percent of S&L mortgages in the 1950s and a high of 60 percent in the 1970s. Mortgages for new homes peaked at a 34 percent share in the 1950s before declining to 26 percent and 20 percent in the 1960s and 1970s respectively. Refinancing in the 1970s took a 10 percent share of the market.

The ratio of FHA new home financing to existing home financing was roughly one-to-one in the

MORTGAGE LENDING AT S&Ls



1980-82

Source: Federal Home Loan Bank Board; NAHB Economic Policy Analysis Division

1950s, it decreased to one-to-three during the 1980-1982 period.

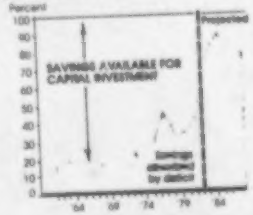
It's only logical that a continuously growing housing stock would increase the amount of credit used for the resale of existing homes. The nation's growing housing inventory has also raised demand in the home improvement market for worthwhile investments on repair, rehabilitation and retrofitting to conserve energy.

Housing critics have perhaps leveled their best case against the use of second mortgages and home equities for personal consumption expenditures, including foreign travel. But even here, the evidence is inconclusive. As Solomon observes:

> ". . . to what extent home repurchasers diverted a portion of the equity from the sale of a home to personal consumption is unclear . . . (But) faced with a slow growth or even a decline in real earnings, it is reasonable to assume, for example, that some of this additional equity was used for furnishings or appliances in the new home, for the purchase of an automobile, for the payment of medical expenses or college tuition, and for other consumption goods."[5]

At a time when the demographic demand for housing continues at a high level, people should be asking whether credit would be better spent for housing or for government borrowing. Because, ultimately, that is where the decision lies.

FEDERAL DEFICIT AS PERCENT OF NET SAVINGS



---

# 4

# The Wealth of Nations—Housing as a Capital Good

Point

"Monetary policy is going to remain tight. Housing is going to continue to be in trouble. Europe is not going to provide support. Government spending is declining. Consumer expenditures are not going to be increased by tax cuts. That's all good news from my point of view, but it doesn't exactly lead to a buoyant economy."

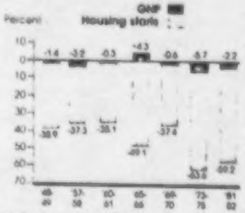
—Dr. Martin Feldstein, chairman, Council of Economic Advisers, from remarks following "What Will the Reagan Economic Policy Do?" October 1981

Counterpoint

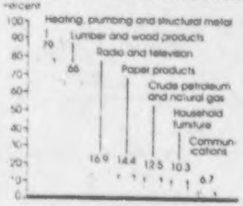
Bad times for housing spell equally bad times for the nation's economy, because housing is the economy's balance wheel, leading the way in and out of the ups and downs of the business cycle. Housing production triggers activity throughout the economy. A new home is the demand center for a multitude of goods and services produced by America's business and industry. Housing is a capital good, a lasting economic resource used to build the wealth of nations.

Since the end of World War II, residential construction has played a central role in stabilizing the economy. The housing sector's sensitivity to fluctuations in the cost of credit has enabled the government to start up or cool off the economy simply by loosening or tightening up the availability of credit. While the housing cycle disrupts productivity and has an inflationary impact upon home prices, it nevertheless has provided government with a tool for controlling economic growth.

**CHANGES IN GNP AND HOUSING STARTS, POST WAR RECESSIONS**



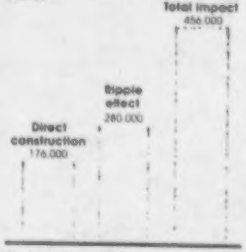
**ECONOMIC OUTPUT GENERATED BY NEW CONSTRUCTION**



Source: U.S. Department of Commerce and Homer Hoyt Institute

**HOUSING AND JOBS**

Worker-years of employment created by construction of 100,000 single family homes



Source: U.S. Department of Labor, NAHB Economics Division

Following each of the nation's post-war recessions, housing has led the way to recovery with an enormous ripple effect, creating jobs, uplifting confidence and stimulating activity throughout the economy. Each 100,000 new single family homes requires 176,000 worker-years of employment to construct. When taking into account the financial, legal and other services involved in selling the units as well as the spinoff purchases of goods and services generated by the home sales, an estimated 280,000 additional worker-years of labor are created throughout the economy.

A new home is not an everyday consumer good. In fact, like traditional business investment, expenditures for housing construction create wealth. They are an investment in the capital stock of the nation.

When we talk about housing, it's important to distinguish between two kinds of capital. Former Federal Reserve Board Governor Sherman Maisel makes the distinction this way:

"One is real capital, the physical goods we don't consume. This is the real investment in our fiscal stock that produces goods and services. The second, financial capital, is the total assets or liabilities of financial institutions."[4] Financial capital, Maisel notes, is just money deposited in institutions, moving from one institution to another. It does not change net wealth.

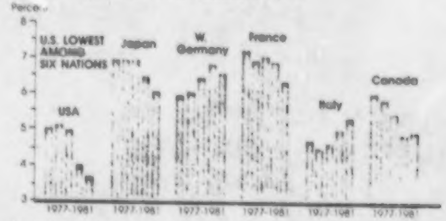
All major industrialized nations have treated their housing stock as a capital good, including Japan, which has produced more housing than the U.S. in the past three years, even though it has half the population. At the same time, Japan has maintained a high level of investment in plant and equipment and extremely high productivity rates. And the record shows that residential investment as a percent of GNP is lower in the U.S. than in any other member nation in the Organization for Economic Cooperation and Development, with the exception of Great Britain.

Barry Bosworth of the Brookings Institution notes:

"Despite the fact that the U.S. has the fastest population growth of the major OECD countries, it is among the lowest in the share of output in residential construction. This is not consistent with the view that the interaction between inflation and the tax laws has led the United States to overinvest in housing at the expense of business investment."[5]

During the tight monetary climate prevalent in the U.S. economy since late 1979, a frequently heard argument has been that capital should be taken out of the housing sector and invested in retooling outmoded plant and equipment. Yet there is no evidence to suggest that investment in housing has hampered efforts to increase the productive capacity of U.S. business and

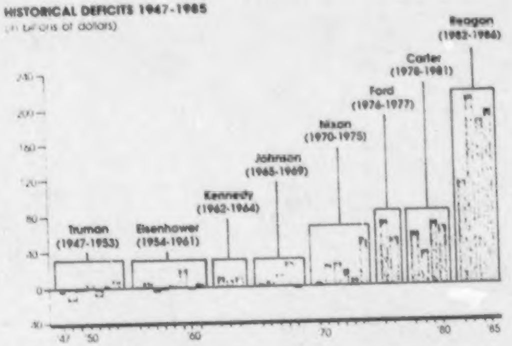
**RESIDENTIAL INVESTMENT AS A PERCENT OF GNP**



Note: For France and Italy, the data is private residential investment as a percent of gross domestic product.

Source: OECD Economic Outlook, Various Issues. Compiled by NAHB Economic Policy Analysis Division.

**HISTORICAL DEFICITS 1947-1985**
(in billions of dollars)



industry. The share of residential expenditures in GNP has varied around 4.8 percent since World War II. The share of gross housing product, which is the total amount the country spends to own, rent and maintain housing, has varied around 9.5 percent, with little change in the last 20 years.

What the country needs now is new investment in housing *and* in reindustrialization. These goals are not in conflict. They never have been. But whether or not they are attained in the 1980s will depend to a great extent on how successfully the federal government reduces its borrowing in the credit markets.

---

# 5

# Housing and Inflation

*Point*

"It might be argued that people are paying higher fractions of their incomes for housing because the price of homes has risen so steeply. But why have home prices risen? Because more people want to own their own homes to capture the financial advantages of doing so."

—Anthony Downs, "Are We Using Too Much Capital for Financing Housing?" Federal National Mortgage Association Symposium, February 10-11, 1981

*Counterpoint*

There's no question that housing was a good financial investment in the 1970s. More than almost any other investment, home equities kept pace with a rapid rise in inflation. But it's highly questionable that the investment factor alone motivated people to buy homes.

The primary motivating factor is that people buy homes because they need a place to live. But the total reality of why people buy homes is less tangible. Homeownership in America is a way of life, a stabilizing force enabling families to establish roots in the community and participate more responsibly in the political discourse of a democratic society. Homeownership was popular in America long before double digit inflation and long before the government established priorities in

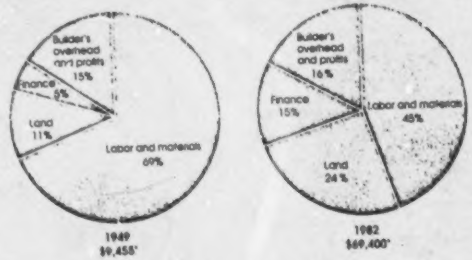
*Counterpoint*

the tax code and financial system to encourage the nation's families to own their own homes.

It's even more questionable that the investment factor is an adequate explanation for the housing inflation of the 1970s. The cost of land, building materials, local regulation, mortgage finance and even the cyclicality of the housing industry have all contributed heavily to inflation in housing.

At a time of strong demographic demand for housing but an inadequate supply, the production of greater numbers of affordable homes is the best way to reduce housing inflation. Reducing capital investment in housing will only make a bad situation worse.

COST COMPONENTS TYPICAL, NEW SINGLE-FAMILY HOME



*Median price

Source: National Association of Home Builders, Bureau of the Census

During the 1970s, the cost of new housing rose 162 percent according to the Census Bureau's C-27 Index, compared to a 112 percent increase in the overall Consumer Price Index.

The two major cost components which contributed most heavily to cost increases were land and financing costs. Land's share of total housing costs surged from under 11 percent following World War II to 24 percent in 1982. The financing component jumped from 5 percent to 15 percent during the same period. Labor and materials, on the other hand, dropped from 69 percent of housing costs in 1950 to 45 percent in 1982.

Regulatory and cyclical constraints on housing production aggravated housing inflation during the 1970s. As demonstrated in numerous studies, including reports by a HUD Task Force[6] and George Sternlieb[7] of Rutgers University, no-growth ordinances, land use regulations, excessive building codes and land development regulations have added as much as 20 percent to the cost of a new home.

Housing production was interrupted by recessions twice during the 1970s. Housing was at the bottom of the business cycle during roughly four years of the decade.

The costs of recession to the industry are well documented. Recessions disrupt building operations, at a high cost to individual construction firms, the majority of which are small businesses. They devastate profits in the thrift industry. They create massive unemployment and underutilization of industrial capacity, so that the costs of retooling and starting up again for normal levels of production are high. All of these costs are ultimately passed along to consumers.

Arthur Solomon has made these observations about the inflationary impact of the housing cycle:

"Over the long run these inefficiencies become institutionalized. And the instability ends up having a pervasive effect on the overall efficiency of the construction industry—its technology, structure and organization. . . . Because of the risk and the uncertainty associated with the building industry, new firms are reluctant to enter the market, and land developers and builders require a relatively high rate of return on their equity. And financial institutions and others tend to raise the cost of construction loans, title insurance, and settlement charges during tight credit conditions to offset the loss of business volume. Finally, because most houses are built during the peak of the cycle when prices are at their highest, new homebuyers pay much of the premium for what is, in effect, instability insurance. This means that the price Americans pay for their housing is higher than it would be with more stable levels of production."[8]

The most recent recession, in tandem with a hangover in inflationary expectations from the 1970s, has had an especially damaging impact upon the nation's system of mortgage finance. Several major changes in the mortgage market explain why the cost of home finance throughout the 1980s is apt to be relatively more expensive than it used to be.

First, it is no longer a safe assumption that the thrift industry will continue to supply the bulk of the nation's residential mortgage money. Its share of the residential mortgage market has declined annually since 1976. In 1982, thrift participation in the home market declined to a net minus $22.7 billion—a post World War II low. By comparison, the industry accounted for an average 44.2 percent share in the 1970s and a peak of 56.7 percent in 1976.

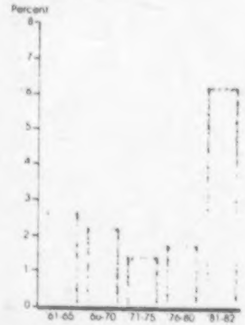
Second, as the competition for loanable funds has increased, the share raised for residential mortgages in the overall credit markets has declined sharply.

Third, savings and loan associations are paying much higher returns to savers. In 1978, the average cost of funds for S&Ls was 6.67 percent. The cost of funds rose to 10.92 percent in 1982 and 11.49 percent during the first half of 1982. In the first half of 1978, earnings on loans exceeded the cost of funds by a profitable 1.9 percent. During the first half of 1982, S&Ls lost money as their cost of funds exceeded earnings on loan portfolios by 1.1 percent.

The most inflationary factor in the housing sector during the first few years of the 1980s was the cost of mortgage finance. Mortgage rates rose to new records. In late 1981, conventional mortgage rates peaked at close to 20 percent. Even the 13 percent loans available during the early months of 1983, when compared to the prevailing rate of inflation, were exceedingly high by historical standards.

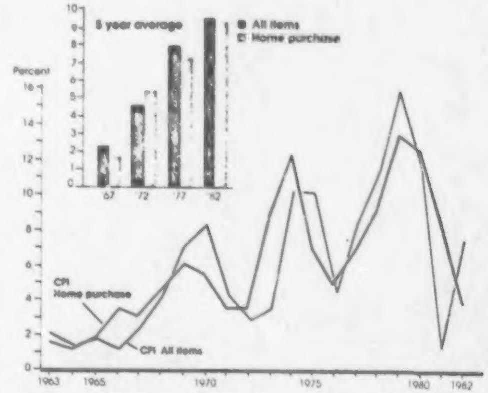
Allegations of purported lower interest rates for residential mortgages cannot be supported by available data. For the past 20 years, home buyers have paid a higher interest rate to finance their mortgages than have major corporations to finance their long-term debt. Effective mortgage interest rates for loans closed have exceeded the yields on long-term AAA corporate bonds by 35-163 basis points. During 1983, NAHB expects the range to widen to 170-210 basis points.

**REAL INTEREST RATE**



Home prices have generally followed the inflation rate, responding to inflationary pressures in the economy, particularly energy prices. The home purchase component of the CPI measures increases in the cost per square foot of new and existing homes in various geographical locations. Between 1963 and 1982, it rose an average 5.9 percent annually, compared to a 6.1 percent increase for the entire CPI.

**CHANGES IN CPI—ALL ITEMS VS. HOME PURCHASE**



Source: Bureau of Labor Statistics. Computation by NAHB Economic Policy Analysis Division

Increases in the financing, taxes and insurance component largely explain why increases in the cost of overall homeownership have been so high. They increased an average of more than 12 percent per year over the past 10 years.

Housing has recently responded to higher costs for mortgage funds, materials and labor by shifting production to smaller, more efficiently built homes in higher-density developments. Condominiums, townhouses and zero-lot-line homes are the market's way of providing affordable housing to large numbers of first-time buyers following a period of high inflation in the housing sector.

Eliminating the sharp peaks and valleys of the housing cycle is ultimately the best way to control housing inflation. For the sake of maximizing productivity in housing and other major sectors of the economy, the government should pursue fiscal and monetary policies that keep housing and the economy running on a more even keel.

## STATEMENT OF WALLACE R. WOODBURY, WOODBURY CORP., SALT LAKE CITY, UTAH, AND CHAIRMAN, TAX SUBCOMMITTEE INTERNATIONAL COUNCIL OF SHOPPING CENTERS, WASHINGTON, D.C.

Mr. **Woodbury**. My name is Wallace R. Woodbury. I appear here on behalf of the International Council of Shopping Centers, for which I serve as chairman of their tax subcommittee. We would like to make these points:

First, the accelerated recovery cost system was enacted to stimulate investment and simplify administration. We think those motivations are just as important and extant today as they were at the time it was enacted, and that the system is showing signs of success.

A common misconception seems to exist as to the degree of benefit to real estate resulting from the 15-year cost recovery period for structures. People look at ACRS as though it cut the recovery period for structures from 40 or 50 years to 15 years. This is a misconception as far as the tax law and actual experience are concerned.

The Treasury regulations for buildings, Rev. Proc. 62.21 and bulletin F, were rarely upheld in practice when determining the economic life of structure under the facts-and-circumstances test.

A study by the Treasury's Office of Industrial Economics, which was published in 1975, supports this conclusion.

A Touche-Ross study of the useful lives of shopping centers that the ICSC commissioned concludes that the economic lives of shopping centers were typically 22 to 26 years under the old law.

Second, the adoption of ACRS in ERTA and its modification in TEFRA was accompanied by other changes in the tax law, which tended to mitigate the advantages of the 15-year recovery period for structures. These changes were the elimination of component depreciation and the option to use the facts and circumstances test in ERTA, and the application of the construction period and investment interest limitations to corporations and the adoption of alternate minimum tax provisions in TEFRA.

Third, due to a bias in the tax laws against investment in structures as compared to investment in equipment, there is a misallocation of capital resources in the economy. This bias has been noted by Jane Gravelle of the Congressional Research Service, by the Council of Economic Advisors, and by the Citizens for Tax Justice. According to Gravelle, this bias causes a misallocation of capital in favor of short-lived assets, producing economy inefficiency in the system which she describes as dead weight loss. She says that under the ACRS as created by ERTA and the TEFRA modified by dead weight loss to the economy result in a loss to the economy of $3.5 to 3.8 billion per year. Any increase in the ACRS life for structures would increase this bias and resulting economic loss.

Fourth, long-term investments in structures require much long-term planning, and that predictability as to the investment risk and the tax consequences is very important. Frequent changes in the tax laws that critically affect investment tend to discourage investment. Such an effect would be unfortunate at a time when we are trying to encourage the investment activities which are so important to our economy. This is especially so when we have 22.1-percent unemployment in the construction industry, and when so many other related industries are dependent on construction in order to sell their goods.

Please give the existing ACRS lives for real estate your blessing and a chance to work longer than just the 2 years that they have been in place.

Thank you very much, Mr. Chairman.

Senator DANFORTH. Thank you, sir.

[The prepared statement follows:]

## PREPARED STATEMENT OF WALLACE R. WOODBURY ON BEHALF OF THE INTERNATIONAL COUNCIL OF SHOPPING CENTERS ON TAX EXPENDITURES

### I. INTRODUCTION

My name is Wallace R. Woodbury. I am Chairman of the Board of Woodbury Corporation, Salt Lake City, Utah, a long-established real estate development, brokerage, management and consulting firm. I am also Chairman of the Tax Subcommittee of the Government Affairs Committee of the International Council of Shopping Centers (ICSC), and I submit this testimony today on behalf of the members of the International Council of Shopping Centers.

The ICSC is a business association of approximately 10,000 members consisting of shopping center developers, owners, operators, tenants, lenders and related enterprises. ICSC represents a majority of the 23,300 shopping centers in the United States in 1982.

### *A. The shopping center industry*

It is estimated that between 5.5 and 6.2 million people are regularly employed in shopping centers and that several hundred thousands more are annually engaged in new construction. The rippling effect of shopping center development on employment in related businesses, including display advertising, maintenance and cleaning, legal and accounting, and the manufacture of goods sold in the centers, is considerable.

It is estimated that in 1982 shopping centers accounted for 43 percent of total U.S. retail sales. By the beginning of the next decade (1990), the shopping center share will likely range between 50 percent and 55 percent. In current dollar value, U.S. shopping center retail sales reached a level of $462.5 billion in 1982.

### *B. Economic benefits of shopping center development*

The extent of the contribution of shopping center development to the nation's productivity is oftentimes not fully appreciated. Many people think of productivity solely in terms of the process leading directly to the manufacture of goods. Others would broaden the concept to include the distribution of those goods to the loading docks of the nation's retail facilities—but not to the distribution of products to the ultimate consumer. The fact is, of course, that retail facilities, as the final link in the chain of distribution, are an integral part of the productive process. Thus, to deny tax benefits to retailers but provide them to manufacturers or distributors is self-defeating and inconsistent since without adequate retail facilities there can be no expansion of the other links in the economic and production chain.

1. *Employment.* Shopping centers generate new jobs and secure existing jobs in a number of ways which represent tangible benefits to the community. Of course, the construction of a center provides employment to all sectors of the building trades. In addition, the ICSC has estimated that the tenants of shopping centers employ one full-time employee for every 400 to 500 square feet of gross leasable area space. Thus, a typical neighborhood or community shopping center of 175,000 square feet anchored by a soft goods store and a supermarket employs between 350 and 435 people. Moreover, many of these people, as recent entrants into the job market, would have been unemployable or marginally employable in industrial or office positions.

The increase in employment generated by shopping center development ripples through the local community as other businesses open or expand to provide the services for the new employees. Each new opening or expansion creates, in turn, new jobs and additional revenues.

2. *Tax Revenues.* The economic impact of shopping center development in local communities is clear. Sales taxes and real property taxes are two of the largest sources of state and local revenue attributable to shopping centers. Other direct contributions to local treasuries include business license revenues and personal property taxes on such things as office and retail equipment and inventories.

For example, a 1975 study published by ICSC included a twelve-year case history of the fiscal impact of a large shopping center in Oak Brook, Illinois. The Oakbrook Regional Shopping Center is as typical of the diverse facilities developed by ICSC members as any one shopping center can be. Nevertheless, the Oak Brook study demonstrates the substantial fiscal benefits to a community from shopping center development.

During the period from 1963 through 1983, the Oak Brook shopping center was the primary source of sales tax revenue for the Village of Oak Brook, Illinois. The shopping center's share of total municipal revenues ranged from a high of 91.3 percent in 1965 to 75.4 in 1973 (the last year for which the study developed data). Even after taking into account the very modest increase in muncipal tax expenditures attributable to the shopping center's presence in Oak Brook (for example, increased police and fire protection and local road maintenance), the ICSC study found that in 1973 Oak Brook received net cash-flow benefits in excess of $1.2 million directly attributable to the shopping center. Without this net revenue source, the report concludes that Oak Brook would have experienced a deficit requiring either a decrease in expenditures or an increase in taxes. In fact, the local tax revenue generated by the shopping center allowed Oak Brook to maintain services without imposing a municipal property tax for a number of years.

### C. Interdependence of the real estate industry

The various sectors of the real estate industry are strongly interrelated. For example, shopping center development and rehabilitation follow very closely new housing starts and rehabilitation. The development and location of housing and job-related real estate such as office buildings, retail stores, and industrial facilities continually interact with one another. In a recent study conducted by the ICSC Research Department, the total square footage of annual U.S. shopping center construction starts (1970 to 1979) was correlated with annual U.S. housing starts (1969 to 1979). Results indicated that 95 percent of the variation in shopping center construction starts could be statistically "explained" by changes in the level of housing starts.

### D. Small business development

The real estate industry is composed almost totally of small firms. Sixty percent of all construction firms and eighty percent of all real estate service firms have four or fewer employees. It is well established that the vast majority of all new jobs are created by small businesses such as these.

Unfortunately, the small business nature of the industry makes it unusually susceptible to changes in economic conditions, financial climate, the tax code and other public policies. During the past, those factors have combined to retard the growth rate of all areas of real estate.

It is important that the consequences of future tax policy changes on this important industry be carefully considered.

## II. PROPOSALS TO CHANGE ACRS AS IT APPLIES TO STRUCTURES

We have been asked to testify today regarding tax expenditures. Capital cost recovery allowances are considered by some persons to be tax expenditures.

The Congressional Budget Office (CBO) has listed the extension of the recovery period for structures from 15 to 20 years as a method of reducing the federal budget deficit.[1]

## III. COMPARISON OF THE COST RECOVERY PERIOD FOR STRUCTURES PRIOR TO AND UNDER ACRS

### A. ERTA and TEFRA changes in depreciation/cost recovery allowances

In 1981, Congress enacted the Economic Recovery Tax Act of 1981 (ERTA). Among the changes in the tax law made by ERTA was the establishment of a new cost recovery system, the Accelerated Cost Recovery System (ACRS). The major differences between pre-ERTA law, under the Asset Depreciation Range (ADR) system, and ACRS are as follows:

---

[1] *Reducing the Federal Deficit: Spending and Revenue Options,* Congressional Budget Office, February 1983, Part III, at 288–289.

1. *Cost Recovery Categories.* ERTA reduced over 100 depreciation life categories to four cost recovery categories.

2. *Recovery Periods.* The recovery periods for equipment were reduced from various periods under the ADR system (ranging from three to 18 years) to five years for most property, and to three years for short-lived property (property with an ADR midpoint life of four years or less).

The cost recovery period for structures was reduced from various periods determined under a facts and circumstances test (generally ranging from 20 to 37 years) to 15 years.[2]

3. *Methods of Cost Recovery.* Most types of property were allowed to use more accelerated methods of cost-recovery than under pre-ERTA law.

4. *Investment Tax Credit.* No investment tax credit was provided for structures. However, the 10 percent investment tax credit for most equipment was continued, and a six percent credit was provided for short-lived property.

In 1982, Congress enacted the Tax Equity and Fiscal Responsibility Tax Act of 1982 (TEFRA). TEFRA eliminated the additional acceleration for equipment previously scheduled to go into affect in 1985 and 1986, and made permanent the temporary ACRS benefits for equipment. TEFRA made no change in the cost recovery rules for structures.

### *B. Cost recovery for structures under pre-ERTA law and ACRS*

The benefits to real estate resulting from the reduced cost recovery periods of ACRS are not as large as sometimes perceived. One source of this misperception is the belief held by some that the recovery periods for structures dropped from 40 to 50 years to 15 years. Under pre-ERTA regulations, the depreciation period for retail buildings advocated by the Treasury and the IRS significantly exceeded the depreciable lives which shopping center industry studies indicate were generally claimed and upheld by the courts.

Under pre-ERTA law, the "component" parts of a building—such as the heating, air conditioning, electrical and plumbing systems, as well as the carpeting and light fixtures—could be separately depreciated at different rates. As a result, the actual weighted-average useful lifes of virtually all buildings were substantially lower than those advocated by the Treasury.

In 1975 the Treasury Department issued a report on the depreciation practices of building owners. The report was based on data collected by the Treasury and on trade association data. The report found that depreciation lives were as low as 15 years for new shopping centers and 7 years for used shopping centers.[3]

A 1973 survey by Touche Ross & Co. of a representative sample group of 89 shopping centers owned by ICSC members established that the useful lives of shopping centers ranged from 22 to 29 years;[4]

The useful lives found in all of these studies were significantly lower than the 50 year life which IRS *Revenue Procedure 62–21* required for retail buildings.

## IV. RELATIONSHIP OF THE COST RECOVERY PERIODS FOR STRUCTURES AND FOR ASSETS PRIOR TO AND UNDER ACRS

The Congressional Research Service (CRS) has published a study of the relative impact of ACRS as established by ERTA on various assets used by the different sectors of the economy. The results of the study indicated that prior law favored investment in equipment assets over structures and that "under ACRS this trend is continued and strengthened."[5] The study found that under ERTA, the effective tax rates for all categories of structures were higher than those for all categories of equipment, and that some classes of equipment actually received a negative tax rate while all categories of structures had a positive tax rate. An excerpt from the CRS study is attached as Exhibit I.

---

[2] J. Gravelle, *Effects of the 1981 Depreciation Revenues on the Taxation of Income From Business Capital,* National Tax Journal Vol. XXXV, No. 1 at 8.

[3] *Business Building Statistics, A Study of Physical and Economic Characteristics of the 1969 Stock of Non-Residential and Non-Farm Business Buildings and Depreciation Practices of Building Owners, 1971,* Office of Industrial Economics, Department of the Treasury, August 1975, at 37–45.

[4] Touche Ross & Co., *Depreciable Lives of Shopping Centers, An Independent Study Prepared for the International Council of Shopping Centers,* 1973.

[5] J. Gravelle, *Effects of the Accelerated Cost Recovery System by Asset Type,* CRS, August 1981, 6.

The conclusions of the CRS study received further support from an analysis prepared by "Citizens for Tax Justice" published on February 19, 1982. The Citizens for Tax Justice analysis indicated that, under ERTA, assets other than structures enjoyed a negative tax rate as a result of ACRS. An excerpt from the study is attached as exhibit II.

In addition, the 1982 Economic Report of the President indicates that ACRS under ERTA favored investment in machinery, equipment and vehicles over that in industrial and commercial buildings.[6]

CRS also has published a study of the impact of ACRS as modified by TEFRA on various types of assets which concludes that, although the bias against structures was reduced by TEFRA, structures are still at a disadvantage compared to other assets.[7]

This same conclusion was reached in a book by the Director of Federal Tax Policy of Citizens for Tax Justice.[8]

According to Jane Gravelle of the Congressional Research Service, under pre-ERTA law, effective tax rates on new investments were 15 percent for equipment and 48 percent for structures (at a 6 percent inflation rate). Under TEFRA, the corresponding rates are 9 percent for equipment and 37 percent for structures.[9] (See Exhibit III for a comparison of effective tax rates by type of asset).

According to Gravelle, the bias in favor of short-lived assets produces a disparity in effective tax rates by type of asset that results in a misallocation of capital. This misallocation of capital produces economic inefficiency, which she describes as "deadweight loss". CRS estimated that the "deadweight loss" resulting from the bias against structures amounted to between $2.7 to $3.3 billion annually under pre-ERTA law, and that the "deadweight loss" increased to from $3.5 to $3.8 billion under ERTA.[10]

Any decrease in the cost recovery allowances for investments in structures will add to the bias of effective tax rates against structures and will increase the "deadweight loss" to the economy.

This bias is demonstrated by a computer analysis made by Coopers and Lybrand for the National Realty Committee using the CLEFS (Coopers & Lybrand Economic Forecasting Simulator), model. This model also is used by the Treasury Department under the acronym MAGPIE (Model for Analysis of Government Policy Impact on Efficiency).

This model has determined that ACRS provided substantially less of an incentive for investments in structures than for investments in other assets.

The CLEFS model shows that although the ACRS reduction of the cost recovery period for structures increased investment in commercial and residential rental structures, such increase was less than the increased investment in other assets which received greater incentives.

For example, according to CLEFS in the first quarter of 1981 the capital stock of commercial and rental residential structures was 2.6 percent higher under ACRS than it would have been under pre-ERTA law. During the same period the capital stock of equipment was 3.3 percent higher.

For the fourth quarter of 1982, these figures are 2.9 percent higher for commercial and rental residential structures and 3.5 percent higher for equipment under ACRS over the levels of capital stock which would have occurred under pre-ERTA law. (See Exhibit IV for CLEFS data comparing the capital stock of various asset types under ACRS and under pre-ERTA law.)

The relatively unfavorable treatment of investment in industrial, commercial and residential building under current ACRS rules can be tolerated by the economy, but such differences should not be expanded further by cutting back on ACRS deductions for structures.

---

[6] Economic Report to the President, February 1982, at 124.

[7] J. Gravelle, *Effective Tax Rates and Tax Charges in the 97th Congress*, CRS, January 3, 1983, at 3, 6.

[8] R. McIntyre, *Inequity and Decline*, 39–42, 103 (1983).

[9] J. Gravelle, *Effective Corporate Tax Rates and Tax Changes in the 97th Congress*, CRS, January 1983, at 6.

[10] J. Gravelle, *Effects of the 1981 Depreciation Revenues on the Taxation of Income from Business Capital, National Tax Journal, Vol. XXXV, at 17.*

## V. REASONS FOR NOT CHANGING THE ARCS RECOVERY PERIODS FOR STRUCTURES

### *A. The current cost recovery period for structures is reasonable compared to the cost recovery periods under prior law*

As discussed in Part III above, the establishment of 15 years as the recovery period for all structures under ERTA resulted in a lesser reduction of the recovery period for structures than would appear from comparing the Treasury guidelines with the 15 year recovery period under ACRS.

Part of the misperception of the size of the tax reduction under the ACRS 15 year recovery period for structures resulted from the failure to consider the net impact of tax law changes enacted in ERTA and TEFRA which reduced the tax benefits of investments in structures. Such changes include the elimination of component depreciation, the imposition of more restrictive construction period interest and tax deduction provisions, the passage of more restrictive investment interest limitations, the adoption of more restrictive recapture rules for those who elect accelerated cost recovery methods, and a larger alternate minimum tax assessment.

In addition, by adopting a uniform cost recovery period some investors, particularly in used structures, sacrificed the right to establish shorter useful lives under a facts and circumstances test. The application of the 15 year ACRS life also substantially benefits the Treasury through reduced administrative costs and more effective time utilization by revenue agents.

### *B. The current cost recovery period for structures is reasonable compared to the benefits given other assets*

As discussed in Part IV above, ACRS already is biased against investments in structures. Lengthening the cost recovery period—and thereby reducing cost recovery allowances—for structures would increase this bias.

The impact of this proposal on investment in real estate has been projected by the CLEFS model by comparing the change in the capital stock of various types of assets. Using the capital stock of these assets under pre-ERTA law as a baseline, the CLEFS model determined the changes in the capital stock levels of these assets caused by ACRS and the changes in the capital stock levels which would be caused by extending the cost recovery period for structures from 15 to 20 years.

According to CLEFS, an increase in the cost recovery period for structures from the current 15 years to 20 years would substantially decrease investment in real estate. CLEFS projected a decline of 1.6 percent in the capital stock of commercial and rental residential structures below the level which would have occurred under pre-ACRS law in the first quarter of 1981 (compared with a 2.6 percent increase under ACRS). For the last quarter of 1982, a 20 year recovery period would produce a decrease of 1.2 percent in the capital stock of commercial and rental residential structures below the level which would have occurred under pre-ACRS law (compared to a 2.9 percent increase under ACRS).

Therefore, extending the cost recovery period for structures from 15 to 20 years would decrease investment in structures, not only below the levels existing under ACRS, but also below the levels which would have occurred under pre-ERTA law. (See Exhibit V for CLEFS data comparing the capital stock of various asset types under ACRS with a 20 year cost recovery period for structures and under ACRS.)

### *C. The proposed increase in the cost recovery period for structures from 15 to 20 years would not increase tax revenues*

CBO has estimated that an extension of the cost recovery period for structures to 20 years would increase federal tax revenues by $400 million in fiscal year 1984 and $1.8 billion in fiscal year 1985.

These figures are illusory and inflated because they do not take into account revenue reductions caused by the resulting decreased economic activity in the construction industry and other industries affected by the level of construction activity.

The CLEFS model indicates that such a proposal would *decrease,* rather than increase, the flow of revenue to the Treasury. The CLEFS model determined that if this proposal were made effective in 1984, there would be a decrease in tax revenues of approximately $300 million in 1984, $500 million in 1985, $1 billion in 1986, and $1.5 billion in 1987.[11]

---

[11] This data is included in the Testimony of the National Realty Committee.

*D. Economic impact*

Changing ACRS as it applies to real estate can be expected to have a negative impact on the economic recovery of the construction and related industries and of the economy as a whole.

1. *Permit ACRS to Work.* ACRS and the other provisions of the Economic Recovery Tax Act of 1981 were adopted in order to stimulate investment. The provisions have been in effect only for a comparatively brief period, and any extension of the ACRS recovery period for structures would significantly limit the incentives granted under ACRS and discourage desperately needed investment in industrial, commercial and residential buildings.

Although the economic recovery has begun, it is fragile and the need to increase saving and investment continues. The benefits to the economy of the increased investment which CLEFS show has occurred under ACRS can be expected to increase with time. This is especially true regarding the benefits from long-term investments such as real estate.

This investment incentive program has been in effect for only two years. Because of the long lead times involved in making many investments, including real estate investments, the impact of this policy is just beginning to be felt in the economy.

2. *Commercial Buildings Are Productive Assets.* Structures are productive assets and increased investment in such assets promotes economic growth. Buildings incorporating technological advancements in insulation, environmental control, lighting, communications, security and other technologies can provide more effective and efficient work environments and increase energy efficiency.

Scientifically planned retail complexes, such as shopping centers promote efficient retail sales activities and efficient markets. They permit a consumer to meet his shopping needs at one location, and reduce the time and energy expended for transportation and the environmental impact of such travel. They also provide head-to-head competition under one roof, thus improving market efficiency. Moreover, they accomplish this in a safe and pleasant atmosphere suitable for the entire family.

3. *ACRS Is a Protection Against the Impact of Inflation.* Although shopping centers may remain standing for many years, their useful lives as effective and efficient retail facilities are limited. It is important that the structures central to our service oriented economy are not allowed to deteriorate and become uncompetitive as have some facilities in industries such as steel and automobiles. As demonstrated by those industries, tax policies which fail to allow adequate capital consumption cost recovery allowances result in obsolete, uproductive, and uncompetitive industries. So long as cost recovery allowances are based on the original rather than the replacement cost of an asset, and so long as there is inflation—at any level—it is necessary to establish cost recovery periods for assets which permit taxation only upon income, and not upon capital.

In addition, long-term debt, which is so vital to investment in structures, continues to require higher interest rates than those required for short-term debt. This retards investment in structures and increases the bias against structures. Additional bias should not be introduced through the tax code.

Although the current rate of inflation is much lower than the extremely high levels reached in 1980, it is still quite high be historical standards and continues to result in a substantial difference between the original and the replacement costs on any long-lived asset.

The consumer price index increased 177 percent in the 15 year period prior to September 1982. Even at the present 3 percent inflation rate, the replacement cost of an asset would increase by 55 percent over 15 years. At a 6 percent inflation rate, the 15 year increase would be almost 140 percent.

The concern about inflation is not irrational since many economists expect that the rate of inflation will increase once the economic recovery gets underway.

4. *Impact of Investment in Real Estate on Construction and Related Industries.* The health of the construction industry is directly dependent on the rate of investment in real estate. In addition, the viability of many other industries is largely dependent upon construction activity. For example, appliances, furniture, and other household goods and the construction materials, industries, including steel, glass, lumber, concrete, construction equipment, and the real estate, building services and management industries also are directly dependent upon the rate of construction.

The unemployment rate in the construction industry presently is 22.1 percent, more than double the national average. Creating a disincentive to construction activity would increase unemployment in the construction industry or, at the very least, would slow the decrease in the present high rate of unemployment in this industry.

5. *Avoid Discouraging Investment Through Unstable Tax Policy.* Investments in new structures require extensive front-end time. Major revisions in the tax code provisions affecting business investments create uncertainty for potential investors and thereby reduce investment.

Also, any such changes in the tax law have an impact on existing investments. This is true even where the change is only prospectively applied because such a change will affect the resale value of the property.

The repeated consideration by the Congress of changes in tax law provisions has had a disruptive effect on the real estate industry and has had the effect of discouraging investment.

## VI. CONCLUSION

A fifteen year recovery period and the acceleration methods provided under ACRS are reasonable methods for the depreciation of structures compared to the benefits given other assets and to the benefits for structures under prior law. Such treatment does not permit taxpayers to obtain tax treatment which is more favorable than immediate expensing of the costs associated with the construction of structures.

ACRS and the other provisions of the Economic Recovery Act of 1981 were adopted in order to stimulate investment. The provision has been in effect only for a brief period, and an extension of the ACRS recovery period for structures or a change in the method of calculating deductions would significantly limit the incentives granted under ACRS and discourage desperately needed investment in industrial, commercial and residential building.

Although no changes should be made in ACRS for any asset types, it is particularly inappropriate to consider stricter rules for structures since any changes would target that segment of the economy which benefits least from ACRS.

EXHIBIT I

TABLE 1. Effective Tax/Subsidy Rates: Selected Assets, Prior Law and the New Accelerated Cost Recovery System (After Phase In)

| Asset Type | Prior Law<br>6% Inflation | Prior Law<br>12% Inflation | ACRS<br>6% Inflation | ACRS<br>12% Inflation |
|---|---|---|---|---|
| Cars | .15 | .36 | - .65 | - .08 |
| Trucks, Buses, and Trailers | .09 | .42 | - 1.08 | - .09 |
| Construction Equipment | .06 | .34 | - .60 | - .07 |
| General Industrial Equipment | .16 | .36 | - .40 | - .05 |
| Industrial Steam Equipment | .31 | .44 | - .27 | - .04 |
| Utility Power Plants | .27 | .36 | .15 | .28 |
| Industrial Buildings | .49 | .53 | .41 | .48 |
| Commercial Buildings | .48 | .51 | .36 | .43 |
| Apartment Buildings | .37 | ~~.39~~ 42 | .31 | .37 |
| Apartment Buildings (low income) | .37 | ~~.39~~ 42 | .30 | .35 |

**The estimates of effective tax rates are based on equations (1) - (4) and assume the following:

| | Value of d | Tax Life/Prior Law Years | Credit Prior Law Percent | ACRS Life Years | Investment Credit |
|---|---|---|---|---|---|
| Cars | .333 | 3 | 3 1/3 | 3 | 6 |
| Trucks, Buses, and Trailers | .254 | 7 | 10 | 5 | 10 |
| Construction Equipment | .172 | 7 | 10 | 5 | 10 |
| General Industrial Equipment | .122 | 8.6 | 10 | 5 | 10 |
| Industrial Steam Equipment | .0786 | 17.5 | 10 | 5 | 10 |
| Utility Power Plants | .0316 | 22 | 0 | 15 | 10 |
| Industrial Buildings | .0361 | 27 | 0 | 15 | 0 |
| Commercial Buildings | .023 | 36 | 0 | 15 | 0 |
| Apartment Buildings | .01 | 32 | 0 | 15 | 0 |

Source: The values of d are taken from "The Measurement of Economic Depreciation", by Charles Hulten and Frank Wykoff (The Urban Institute, December 1, 1980) except for apartment buildings where the rate is assumed at .01. Under prior law, depreciation calculations assume sum of years digits for equipment assets (including power plants) and apartment buildings; 150 percent declining balance for industrial and commercial buildings. ACRS depreciation is based on schedules in the legislation and 175 percent declining balance for structures, except for low income housing which is based on double declining balance.

EXHIBIT II

## TABLE II-4
## EFFECTIVE CORPORATE TAX RATES ON THE INCOME FROM NEW INVESTMENTS UNDER THE REAGAN ACCELERATED COST RECOVERY SYSTEM

| Type of Asset | Effective Corporate Tax Rate | | | | | |
|---|---|---|---|---|---|---|
| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 |
| Office, computing, & acct. machinery | -30% | -53% | -67% | -70% | -178% | -194% |
| Trucks, buses, and trailers | -28% | -48% | -60% | -63% | -150% | -163% |
| Autos | -20% | -37% | -48% | -52% | -83% | -97% |
| Aircraft | -20% | -33% | -40% | -42% | -84% | -89% |
| Construction machinery | -19% | -31% | -37% | -39% | -77% | -81% |
| Mining and oil field machinery | -18% | -29% | -35% | -37% | -72% | -76% |
| Service industry machinery | -18% | -29% | -35% | -37% | -72% | -76% |
| Tractors | -18% | -29% | -35% | -37% | -71% | -75% |
| Instruments | -17% | -27% | -32% | -33% | -64% | -67% |
| Other equipment | -17% | -27% | -32% | -33% | -64% | -67% |
| Metalworking machinery | -14% | -22% | -26% | -27% | -50% | -52% |
| General industrial equipment | -14% | -22% | -26% | -27% | -50% | -52% |
| Electrical machinery | -13% | -21% | -25% | -26% | -48% | -50% |
| Furniture and fixtures | -13% | -20% | -24% | -25% | -44% | -46% |
| Special industry machinery | -12% | -19% | -22% | -23% | -41% | -43% |
| Agricultural machinery | -11% | -18% | -21% | -22% | -39% | -41% |
| Fabricated metal products | -11% | -17% | -20% | -21% | -37% | -38% |
| Engines and turbines | -10% | -15% | -18% | -19% | -32% | -33% |
| Ships and boats | - 9% | -15% | -17% | -18% | -31% | -32% |
| Railroad equipment | - 9% | -13% | -16% | -16% | -28% | -29% |
| Mining exploration, shafts, & wells | - 8% | -12% | -14% | -15% | -25% | -25% |
| Residential buildings | +31% | +29% | +29% | +29% | +29% | +29% |
| Commercial buildings | +36% | +34% | +34% | +34% | +33% | +33% |
| Industrial buildings | +39% | +37% | +37% | +37% | +37% | +37% |
| WEIGHTED AVERAGES: | - 8% | -18% | -23% | -25% | -58% | -63% |
| MAXIMUM GAP BETWEEN RATES (MAXIMUM DISTORTION EFFECT): | 69% | 90% | 104% | 107% | 215% | 231% |

NOTES: Negative numbers mean government subsidies for the investments, in the form of reduced taxes on other income or through tax leasing. Weighted averages are based on each asset category's share of 1978 corporate investment. (Assets covered represent 87% of 1978 corporate investment.)

SOURCES: Based on data, methodology, and sources from the Economic Report of the President, February 1982, page 123. (An apparent typographical error in the report, dealing with trucks, trailers and buses, has been corrected.)

Citizens for Tax Justice
February 19, 1982

CRS-6

EXHIBIT III

Table 2. Effective Tax Rates on New Investment

| | Pre-1981 Law | | Permanent ACRS | | TEFRA | |
|---|---|---|---|---|---|---|
| | 6% Inflation | 9% Inflation | 6% Inflation | 9% Inflation | 6% Inflation | 9% Inflation |
| | | | By Broad Asset Type | | | |
| Equipment | 15 | 26 | -29 | -10 | 9 | 20 |
| Structures | 42 | 44 | 30 | 34 | 33 | 36 |
| Public Utility | 27 | 32 | 14 | 21 | 25 | 30 |
| Oil & Gas | 9 | 10 | 9 | 10 | 9 | 10 |
| Buildings | 48 | 50 | 37 | 40 | 37 | 40 |
| Total | 33 | 38 | 15 | 22 | 25 | 31 |
| | | | By Industry | | | |
| Agriculture | 29 | 34 | 15 | 22 | 25 | 30 |
| Mining | 27 | 31 | 10 | 16 | 19 | 26 |
| Oil Extraction | 13 | 16 | 10 | 12 | 12 | 15 |
| Construction | 18 | 28 | -13 | -2 | 13 | 25 |
| Manufacturing | 37 | 42 | 18 | 25 | 29 | 33 |
| Transportation | 27 | 33 | 0 | 10 | 19 | 27 |
| Communications | 25 | 31 | -2 | 8 | 16 | 25 |
| Radio/TV Broadcasting | 31 | 38 | 2 | 12 | 19 | 27 |
| Electric, Gas | 27 | 32 | 12 | 19 | 25 | 30 |
| Trade | 40 | 44 | 23 | 29 | 30 | 35 |
| Services | 39 | 43 | 22 | 27 | 29 | 34 |

Source: Congressional Research Service. Assumes a 4.6 percent real discount rate, based on a weighted average of the aftertax real interest rate and the return to equity.

EXHIBIT IV
6/15/83

ERTA (REVISED DEP ASSUMPTIONS) PERCENT DIFFERENCES FROM BASELINE

| | 01:1 | 01:2 | 01:3 | 01:4 | 02:1 | 02:2 | 02:3 | 02:4 |
|---|---|---|---|---|---|---|---|---|
| ALL CAP ASSET TYPES | -.067 | .024 | .111 | .195 | .275 | .361 | .472 | .581 |
| ALL EQUIPMENT | 3.304 | 3.577 | 3.618 | 3.483 | 3.339 | 3.388 | 3.291 | 3.517 |
| ALL STRUCTURES | -.276 | -.239 | -.133 | .029 | .148 | .252 | .393 | .467 |
| EXCL OOH | 4.702 | 4.880 | 5.075 | 5.067 | 5.198 | 5.368 | 5.026 | 5.146 |
| EXCL INV & OOH | 4.102 | 4.324 | 4.454 | 4.355 | 4.403 | 4.524 | 4.275 | 4.441 |
| ALL EXCL COMM & RENT RES | -.785 | -.648 | -.590 | -.480 | -.436 | -.373 | -.094 | .026 |
| ALL EQUIPMENT | 3.304 | 3.577 | 3.618 | 3.483 | 3.339 | 3.388 | 3.291 | 3.517 |
| ALL STRUCTURES | -1.529 | -1.560 | -1.487 | -1.254 | -1.176 | -1.181 | -.691 | -.610 |
| EXCL OOH | 7.969 | 8.127 | 8.249 | 8.179 | 8.142 | 8.385 | 8.384 | 8.522 |
| EXCL INV & OOH | 4.915 | 5.145 | 5.219 | 5.059 | 5.006 | 5.097 | 5.023 | 5.245 |
| COMM & RENT RES STR | 2.561 | 2.793 | 3.027 | 3.021 | 3.259 | 3.443 | 2.014 | 2.875 |
| COMMERCIAL STR | 5.472 | 5.753 | 5.983 | 5.888 | 6.090 | 6.296 | 5.584 | 5.671 |
| RENTAL RES STR | -.579 | -.330 | -.104 | -.088 | .178 | .354 | -.283 | -.234 |

ERTA (REVISED DEP. ASSUMPTIONS)
5 YR LIFE

PERCENT DIFFERENCES FROM BASELINE

6/15/83

EXHIBIT V

| | 81:1 | 81:2 | 81:3 | 81:4 | 82:1 | 82:2 | 82:3 | 82:4 |
|---|---|---|---|---|---|---|---|---|
| ALL CAP ASSET TYPES | .011 | .070 | .118 | .150 | .203 | .254 | .319 | .391 |
| ALL EQUIPMENT | 4.262 | 4.533 | 4.554 | 4.274 | 4.189 | 4.230 | 4.061 | 4.275 |
| ALL STRUCTURES | -.928 | -.926 | -.850 | -.726 | -.642 | -.582 | -.491 | -.465 |
| EXCL C&H | 1.580 | 1.609 | 1.713 | 1.816 | 1.891 | 1.965 | 1.930 | 1.984 |
| EXCL INV & OOH | 2.761 | 2.886 | 2.954 | 2.892 | 2.897 | 2.954 | 2.877 | 2.998 |
| ALL EXCL COMM & RENT RES | .300 | .446 | .475 | .483 | .500 | .549 | .667 | .762 |
| ALL EQUIPMENT | 4.262 | 4.533 | 4.554 | 4.274 | 4.109 | 4.230 | 4.061 | 4.275 |
| ALL STRUCTURES | -.651 | -.661 | -.610 | -.501 | -.452 | -.392 | -.192 | -.142 |
| EXCL OOH | 6.325 | 6.427 | 6.494 | 6.410 | 6.346 | 6.455 | 6.470 | 6.646 |
| EXCL INV & OOH | 4.962 | 5.174 | 5.213 | 5.082 | 4.924 | 4.990 | 4.882 | 5.079 |
| COMM & RENT RES STR | -1.590 | -1.567 | -1.452 | -1.270 | -1.114 | -1.052 | -1.191 | -1.220 |
| COMMERCIAL STR | 1.145 | 1.277 | 1.489 | 1.431 | 1.508 | 1.686 | 1.279 | 1.284 |
| RENTAL RES STR | -4.530 | -4.569 | -4.486 | -4.215 | -4.055 | -4.010 | -3.941 | -3.994 |

## STATEMENT OF ALAN J. B. ARONSOHN, ESQ., ROBINSON, SILVERMAN, PEARCE, ARONSOHN & BERMAN, N.Y., NEW YORK: TAX COUNSEL, NATIONAL REALTY COMMITTEE, WASHINGTON, D.C.

Mr. ARONSOHN. My name is Alan Aronsohn. I am appearing on behalf of the National Realty Committee. I am accompanied by Dr. William Rule, who is the director of economic analysis, Coopers and Lybrand, and they have done some statistical studies for us.

I will simply summarize our position as briefly as I can and ask your permission to file a detailed statement.

Basically, the only justification for a tax expenditure is the thought that it is needed and that it works. We believe, at least at this juncture in the history under ACRS, that ACRS was needed and that it does work. And that includes the treatment of ACRS of real property recovery periods.

As Mr. Woodbury just finished saying, under the ACRS system as it now exists there is a bias which many people have recognized in favor of short-term assets such as machinery and equipment. And it is clear that if we extended the recovery period for real property without making any other changes in the code, that bias would simply be exacerbated. In fact, Dr. Rivlin, who testified here earlier this morning, referred in her written statement to the fact that the cost of extending the real property recovery period from 15 years to 20 years might well be a further distortion of investment allocation.

Our most important reason for suggesting that you hesitate to accept any suggestion for extending the depreciable life for real property is that the motivation behind it, apparently, is to raise revenue. Our studies indicate that it would not raise revenue, at least not within the immediately foreseeable future. Unless we are going to change depreciable lives for people who currently own property, any change lengthening the life for a depreciable asset is going to apply only to new owners who put the property in service subsequent to the time that the change becomes effective. At the same time, a detrimental change in depreciation cuts down the number of new owners because real property will not be as attractive as an investment to new buyers if they have to write their cost off over 20 years instead of 15. Therefore, you have the immediate revenue effect of less activity as the result of this imposition of a tax detriment on the activity and the increased revenue that you are going to get from the lower deductions in future years is going to be postponed to the outyears.

ACRS is a very recently enacted system. The Congress introduced it less than 2 years ago. We believe that, while it is proper to periodically reexamine tax expenditures to see whether they are still worthwhile and still doing the job that they were called upon to perform, it is much too early to think of any radical change in the treatment of the ACRS rules for real property.

Thank you very much.

[The prepared statement follows:]

## PREPARED STATEMENT OF THE NATIONAL REALTY COMMITTEE

### I. INTRODUCTION

My name is Alan Aronsohn. I am a member of the New York City law firm of Robinson, Silverman, Pearce, Aronsohn and Berman. I am here today in my role as tax counsel to National Realty Committee, Inc. (NRC), a non-profit business league of owners and developers of commercial, residential and other real property throughout the United States.

The NRC submits this statement in response to an announced review of tax expenditures by the Committee. The NRC understands that this review is partly prompted by the immediate need of the Committee to "locate" additional revenue to comply with the requirements of the first Congressional concurrent budget resolution for fiscal year 1984.

The NRC intends to address itself to the role of real estate in the U.S. economy, the degree of sensitivity within the real estate sector of the economy to tax law changes, and the 15-year capital cost recovery period for real property under ACRS. In short, the NRC contends real estate's role in a healthy U.S. economy is significant; real estate's sensitivity to tax law changes is substantial; and, due to this sensitivity, an extension of the current 15-year ACRS recovery period to a longer period, as suggested by some, would result in decreased, rather than increased, Federal revenues and an exacerbation of the historical tax bias against investment in structures.

### II. WHY NRC OPPOSES EXTENSION OF 15-YEAR ACRS WRITEOFF PERIOD

In order to raise additional revenue and reduce the Federal deficit, suggestions have been made, in particular by the Congressional Budget Office, to lengthen the recovery period for depreciable real property under ACRS from 15 years to 20 years. Simply put, the NRC opposes any such extension of the recovery period for depreciable real property for a series of reasons.

A. ACRS, including the portions thereof applicable to real property, was intended to produce increased investment and savings; it has done so. (see attached Table 1 and Chart 1). It continues to do so.

While the economy has been picking up and the worst ravages of inflation have abated, large areas of the country still require economic rejuvenation, unemployment is still too high (twice the national average in the construction industry), and inflation, while moderated, is still a force to be reckoned with.

The problems for which ACRS was an intended remedy are therefore still with us.

B. The 15-year recovery period for real property represented a compromise. In 1981, during the debates attending the introduction of ACRS, substantial sentiment existed in favor of the 10–5–3 depreciation system under which real property would have been assigned a 10-year recovery period, twice the recovery period for most machinery and equipment. The NRC did not support 10–5–3, with its attendant 10-year recovery period for depreciable real property, but did ultimately support the ACRS 15-year recovery period for real property, even though this resulted in a recovery period for depreciable real property that was 3 times as long as that applicable to most machinery and equipment.

Extending the recovery period at this time for depreciable real property to 20 years would have the effect of increasing recovery period ratios between real and personal property from 3–1 to 4–1. There is no apparent justification for such a disparity. All evidence indicates that effective tax rates applicable to real property investments already substantially exceed those applicable to manufacturing (See attached Table 3).

C. ACRS was enacted less than 2 years ago. Rapid changes in fundamental tax law affecting investment assets create unnecessary and counterproductive uncertainties in investment markets. At this point, there is nothing to be gained by lengthening real property recovery periods and everything to lose. The direct Treasury revenue gains that would result from the stretch-out would only apply to property placed in service by a taxpayer after the effective date of the change, and the change itself would dampen the rate at which real property would be newly placed in service. In fact, investment in real property structures would substantially decrease, dangerously close to pre-ACRS levels (See attached Chart 3). Calculations performed by Coopers & Lybrand for us indicate that for the immediate future the revenue effect of the change would be negative (See Table 2), thereby voiding the reason for which the 15-year ACRS period would be extended, i.e., to raise Federal revenues.

That concludes my oral remarks for today. With your permission, the National Realty Committee submits the following for inclusion in the Committee's printed record of the hearing.

### III. NRC'S ECONOMIC STUDY

Since 1972 the NRC has actively involved itself in a continuing economic study of the place occupied by the real estate industry in the United States economy. For many years Dr. Norman B. Ture worked as a consultant with the NRC in this endeavor. His independent work and work in behalf of the NRC during the 1970's resulted in the development of two economic forecasting computer models, one for the entire U.S. economy (ATIM) and one, a submodel proprietary to NRC, for the real estate subsector of the United States economy.

As a result of Dr. Ture's association with the NRC, the NRC published in 1973 and 1977 comprehensive economic studies of the place held by real estate in the U.S. economy. These studies made it all clear to all, including Congress, that real estate is a major factor in the U.S. economy which must be taken fully into account when a tax bill is considered. Key aspects of this study have been updated through 1981.

Building on the ATIM model, the accounting firm of Coopers & Lybrand has developed an economic forecasting simulator, called CLEFS, which can analyze the effects of various proposed tax law changes on the economy and on investment in real estate. CLEFS can be used in conjunction with the NRC's real estate submodel (now updated by Coopers & Lybrand) to render greater detail and information regarding the effects of such tax changes on the real estate sector of the economy.

To better prepare its case before Congress in 1983, and to assist the Committee in its review of certain tax expenditures, NRC asked Coopers & Lybrand to asesss through the use of CLEFS the comparative gain or loss to commercial and rental residential real estate investment stemming from the 1981 tax bill (ERTA) and the 1982 tax bill (TEFRA). And because the option was contained in the Congressional Budget Office's February 1983 report entitled "Reducing the Deficit: Spending and Revenue Options" NRC also asked Coopers & Lybrand to anaylze the effect extension of the current 15-year ACRS writeoff period for structures to 20 years would have on Federal revenues and investment in the real estate sector. The results arrived at by Coopers & Lybrand are contained in Section V of this statement.

### IV. REAL ESTATE IN THE U.S. ECONOMY

Its Role is Significant and its Sensitivity to Tax Law Changes is Substaintial.

Both the NRC's updated economic study of real estate's role in the economy and the output of CLEFS indicate that the industry is highly sensitive to tax changes to which it is exposed. Given the demands by real estate on other industries and the dependence of virtually all economic sectors on the products and services of the real estate industry, tax changes which adversely affect real estate impede progress throughout the economy.

Three sets of findings support these observations:

A. The real estate industry—defined as private contract construction, real estate services, and financial services allocated to real estate—is the fourth largest U.S. industry.

In 1981, real estate produced $275.5 billion—12.2 percent—of private business sector's GNP.

Real estate has made a major contribution to the long-term expansion of total output of the U.S. economy. Since 1947, real estate GNP has increased at an average annual rate of 3.3 percent, about the same rate as that for the total private business sector (measured in constant 1972 dollars). The industry's growth slowed considerably after 1970; its constant dollar GNP growth rate fell to 2.4 percent for the years 1971–1981, compared with 3.0 percent for the total private business sector in the same period.

The real estate industry provided 5,996,000 jobs in 1981, about one out of every 12 in the private sector. Employment in the industry grew almost a third again as fast as in the private sector as a whole from 1947 through 1981. (2.1 percent in real estate vs. 1.6 percent in the private sector as a whole)

The physical structures which are the real estate industry's principal final products are a major part of the total stock of real capital in the United States. In 1981, the value of privately-owned structures was nearly 4.2 trillion. The amount of this capital measured in constant dollars has increased at an average rate of 3.5 percent a year since 1947, but has grown at a much slower rate—2.6 percent—since 1971.

B. While very large in terms of total output and employment, the real estate industry consists predominantly of a very large number of very small business establishments.

In 1980, there were almost 417,000 contract construction and almost 170,000 real estate service establishments. These firms are important parts of the business life of every state and city.

Over 90 percent of the contract construction establishments employ 20 or fewer employees.

95 percent of real estate service establishments employed 20 or fewer persons.

C. Demands by the real estate industry generate substantial amounts of income and employment throughout the U.S. economy.

In 1981, nearly 2.4 million employees in other industries were producing things required by the real estate industry.

With the nearly 6 million persons employed directly in real estate, total employment generated by real estate was about 8,350,000, about one of every 9 jobs in the private sector.

The National Income generated in the real estate industry and in other industries in meeting real estate demands amounted to about $303 billion in 1981—about one-eighth of the U.S. National Income.

These facts afford a shop perspective about the real estate industry. It is a highly fragmented industry with a major impact on the American economy. Yet, because it is predominantly an industry of very small, nondiversified business units, real estate is unusually susceptible to changes in borad economic conditions, in the financial climate, and in public policies.

The historical record also shows that the vigorous long-term growth of the real estate industry has not generated comparable increases in returns to investors. Over the period 1947 through 1981.

Gross pretax equity income—proprietors' income, corporate profits, personal rental income, and depreciation allowances (all in current dollars)—increased at an average annual rate of 6.8 percent compared with 8 percent for total current dollar GNP originating in real estate.

As a share of real estate GNP, gross pretax equity income has declined steadily, from almost 64 percent in 1947 to less than 44 percent in 1981.

In view of these trends, tax policy makers should carefully evaluate the effects of their policy decisions on the capacity of the industry to attract the saving which, in real terms, finances investment in real estate. Increasing the rate of tax on the returns on scuh investment will mean retarded growth in the stock of private housing and industrial and commercial structures.

Our study also details the contribution of the real estate industry to the financing of the public sector. In 1979, the industry generated just over $41 billion in Federal tax receipts, about 8.4 percent of total Federal tax revenues. In the same year, real estate accounted for close to $70 billion of taxes at the state and local government level, about 29 percent of these government's tax receipts.

Slowing the growth of real estate, it should be clear, sooner or later must also retard the growth in state and local governments' financial capacity to provide public services.

The conclusions to be drawn from the preceding profile of the real estate industry are virtually inescapable:

The private real estate industry plays a large and critical role in the American economy.

It is the financial mainstay of our states and localities.

The future capability of the industry to contribute to the economy's growth and well being will depend heavily on the weight of taxes on real estate investment. Tax changes adverse to the industry's growth will affect all segments of the economy and every region, state, and locality in the United States.

### V. CLES'S ANALYSIS OF THE IMPACT OF CAPITAL RECOVERY CHANGES IN 1981 AND CBO'S PROPOSED CHANGE IN 1984 ON ECONOMIC ACTIVITY

The following tables and charts have been prepared for the National Realty Committee by Coopers & Lybrand. the analysis was performed using Coopers & Lybrand's Economic Forecasting Simulator (CLEFS).

Three simulation runs were done. A baseline case was run assuming pre-ERTA capital recovery provisions. This is identified in the following exhibits as the "prior law" simulation. A second simulation was run reflecting the changes in the capital recovery provisions due to ERTA. This "present law" case includes changes made as a result of TEFRA. The final simulation is of a change from 15 to 20 year depreciable lives for all structures.

As can be seen in Table 1, equipment was given advantageous treatmen relative to structures as a result of the ERTA capital recovery changes. If the lvies for all structures are increased beginning in 1984, the simulations hsow a decline in investment and Federal tax revenues from what would otherwise be the case (see Table 2).

A significant effect of the increased lives for structures is to heighten the historical disparity in the treatment of equipment relative to structures. Table 2 shows that the capital stock level for equipment would increase relative to the "present law" case. However, the capital stock level would decrease relative to the "present law" case for structures. furthermore, commercial and rental residential structures would tend to be pushed back to simulated pre-ERTA levels (see Table 2 and Chart 3).

## TABLE 1. COMPARISON OF PRESENT LAW (ERTA AS AMENDED BY TEFRA) TO PRIOR LAW TRENDS

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|---|---|---|
| **Differences from Prior Law (billions of $)** | | | | | | | |
| Investment | 18.8 | 23.1 | 28.3 | 35.0 | 41.9 | 48.3 | 55.6 |
| Federal Tax Revenues | .6 | 1.2 | 1.6 | 2.8 | 3.8 | 5.1 | 6.9 |
| Investment (1972 $) | 10.4 | 12.0 | 13.6 | 15.7 | 17.8 | 19.4 | 20.9 |
| Federal Tax Revenues (1972 $) | .4 | .6 | 1.1 | 1.3 | 1.6 | 2.1 | 2.6 |
| Capital Stock (1972 $) | | | | | | | |
| Equipment | 18.8 | 19.6 | 23.1 | 26.0 | 27.3 | 30.3 | 33.8 |
| Commercial and Rental Residential Structures | 13.4 | 15.0 | 15.0 | 17.5 | 22.3 | 26.1 | 30.2 |
| **Percentage Differences from Prior Law** | | | | | | | |
| Investment | 4.12 | 4.61 | 5.25 | 5.12 | 5.55 | 5.88 | 6.01 |
| Federal Tax Revenues | .07 | .11 | .17 | .22 | .29 | .37 | .46 |
| Investment (1972 $) | 4.13 | 4.63 | 5.28 | 5.15 | 5.57 | 5.88 | 5.98 |
| Federal Tax Revenues (1972 $) | .11 | .19 | .34 | .35 | .44 | .54 | .64 |
| Capital Stock (1972 $) | | | | | | | |
| Equipment | 3.15 | 3.11 | 3.46 | 3.78 | 3.77 | 4.00 | 4.2 |
| Commercial and Rental Residential Structures | 2.84 | 3.09 | 2.96 | 3.30 | 4.03 | 4.55 | 5.0 |

Prepared by Coopers & Lybrand for the National Realty Committee (6/27/83)

## TABLE 2. COMPARISON OF PROPOSED LAW (20-YEAR LIFE FOR STRUCTURES) TO PRESENT LAW TRENDS

| | 1984 | 1985 | 1986 | 1987 |
|---|---|---|---|---|
| Differences from Prior Law (billions of $) | | | | |
| Investment | -10.6 | -13.0 | -15.6 | -18.2 |
| Federal Tax Revenues | -.3 | -.5 | -1.0 | -1.5 |
| Investment (1972 $) | -4.7 | -5.5 | -6.2 | -6.9 |
| Federal Tax Revenues (1972 $) | -.1 | -.4 | -.4 | -.6 |
| Capital Stock (1972 $) | | | | |
| Equipment | 5.9 | 5.6 | 5.3 | 4.8 |
| Commercial and Rental Residential Structures | -20.4 | -22.4 | -24.5 | -26.9 |
| Percentage Differences from Prior Law | | | | |
| Investment | -1.48 | -1.64 | -1.79 | -1.86 |
| Federal Tax Revenues | -.06 | -.05 | -.07 | -.10 |
| Investment (1972 $) | -1.48 | -1.64 | -1.79 | -1.85 |
| Federal Tax Revenues (1972 $) | -.03 | -.17 | -.10 | -.14 |
| Capital Stock (1972 $) | | | | |
| Equipment | .82 | .75 | .67 | .58 |
| Commercial and Rental Residential Structures | -3.63 | -3.84 | -4.01 | -4.19 |

Prepared by Coopers & Lybrand for the National Realty Committee (6/27/83)

TABLE 3.

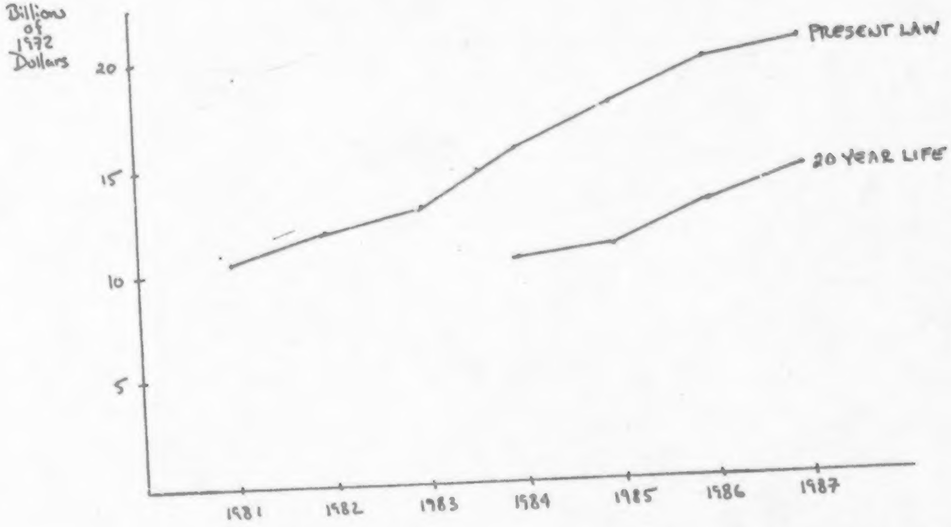
Combined Corporate and Personal Effective Tax Burdens on New Investment Under Alternative Tax Schemes

| | Inflation | |
|---|---|---|
| | 6% | 9% |
| Fixed Capital | | |
| A. Pre-1981 Law | | |
| Equipment | 26% | 31% |
| Public Utility Structures | 36 | 37 |
| Other Structures (primarily buildings) | 52 | 52 |
| B. Permanent ACRS Provisions | | |
| Equipment | -12 | -5 |
| Public Utility Structures | 25 | 26 |
| Other Structures | 43 | 43 |
| C. Current Law (TEFRA) | | |
| Equipment | 21 | 26 |
| Public Utility Structures | 35 | 35 |
| Other Structures | 43 | 43 |
| Land | 53 | 50 |
| Inventories | 66 | 65 |
| Combined Aggregate Tax Burdens | | |
| Pre-1981 Law | 48 | 48 |
| Permanent ACRS Provisions | 39 | 40 |
| Current Law (TEFRA) | 44 | 45 |
| No Corporate Tax | 33 | 38 |
| Expensing of Investment | 13 | 7 |

Source: "Effective Corporate Tax Rates and Tax Changes in the 97th Congress", Congressional Research Service, The Library of Congress, Jane G. Gravelle, Specialist in Industry Analysis and Finance, Economic Division, January 3, 1983.

Chart 1

Gross Private Domestic Investment - Differences from Prior Law (Pre-ERTA)

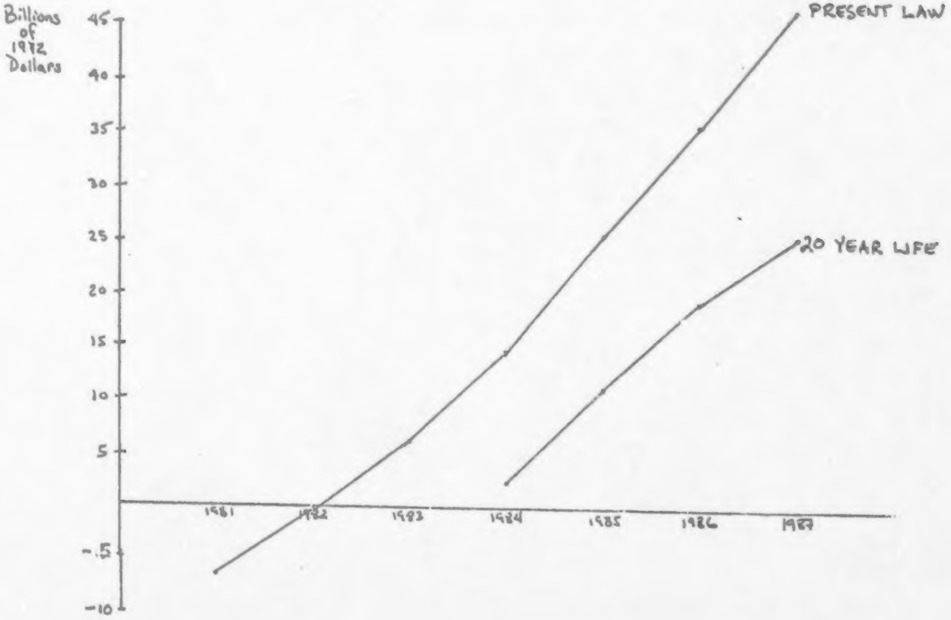


Prepared by Coopers & Lybrand for the National Realty Committee
(6/27/83)

Note: Gross Private Domestic Investment consists of purchases by private businesses of fixed capital goods (equipment and structures) plus the value of the change and the physical volume of inventories held by private businesses.

Chart 2

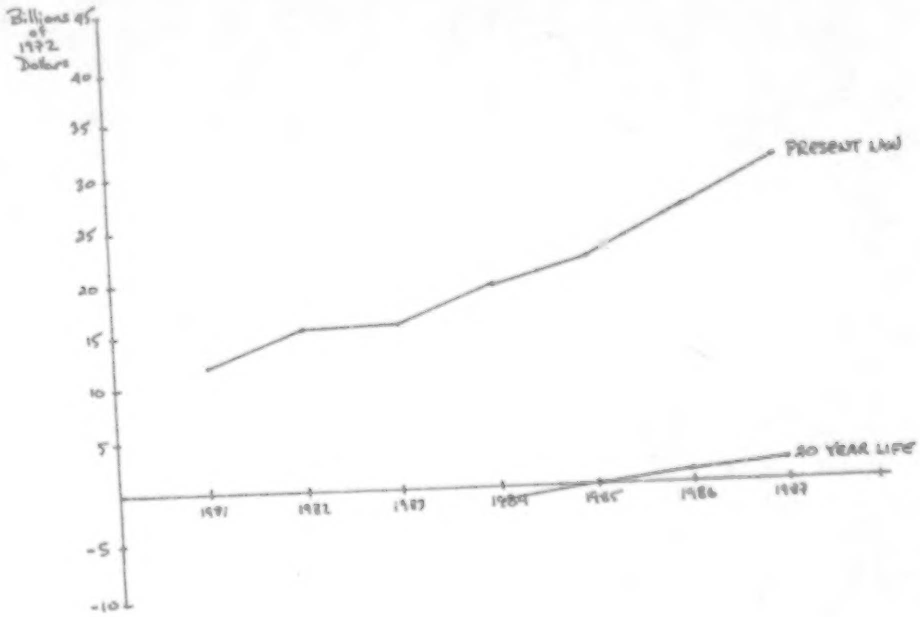
Stock of Structures - Differences from Prior Law (Pre-ERTA)



Prepared by Coopers & Lybrand for the National Realty Committee
(6/27/83)

Chart 3

Stock of Commercial and Rental Residential Structures - Differences from Prior Law (Pre-ERTA)



Prepared by Coopers & Lybrand for the National Realty Committee (6/27/83)

Senator DANFORTH. Senator Long?

Senator LONG. I just want to state my position for the record, for the panel and for anybody else who is interested.

It is my thought that we should not have a tax increase like this unless it is coupled with some kind of assurance that we will have a major cut in spending. Personally, I think that spending cuts ought to exceed what we are called upon to raise in taxes—I would hope maybe at least 2 for 1.

I don't want to be fiscally irresponsible, but I think that most people in the country would prefer that we reduce spending. I am talking about most taxpayers—they would prefer that we reduce spending instead of raising taxes. It looks like it may be required to do both; but if that should be the case, I think that they have a right to demand and insist that if we are going to have a tax increase, it ought to be a part of a package where there will be major cuts in Federal spending. In fact, the last time we had a balanced budget, that's what the combination was—a big cut in spending, accompanied by a big tax increase. That's point No. 1.

Point No. 2: I am not at all convinced that in raising money, we would better raise it by striking at first one industry and the next another, as is being suggested by having a hearing on tax expenditures, rather than something that would be a more broad, sweeping, across-the-board type revenue measure where everybody pays his part.

In my judgment, I don't think we can afford the third stage of that tax cut that is in the law now. We should have deferred the third stage, held it off until we can afford it—not just putting a cap on the third stage, but defer the whole 10-percent cut that is going into effect in July.

The President was determined not to do business that way and not to defer that tax cut, so I assume that it's going to go into effect. But let me just say that as far as my part of the tax cut is concerned as an individual, I would cheerfully give up my part just to make my share of the contribution in doing what has to be done to get the Government's finances in order.

When this matter is behind us, I believe that we ought to take a look at how we can raise a large amount of money by some kind of tax that would apply across the board, where everybody is going to pay a share, especially everybody in this room. I don't think we want to tax welfare clients; but, aside from needy persons, it seems to me that taxpayers ought to be asked to do their share toward raising the large amount of money it is going to take if we are going to have fiscal responsibility, where we cut spending and raise taxes.

It won't be so burdensome on anybody if we can spread the burden so that everybody is a part of it. But I think if you zero in on any one of these industries represented here, as has been suggested by some witnesses, you are going to do immeasurable injury. And I believe if you do that, as has been suggested by some with regard to this industry that is so well-represented here before us today at this moment, it will do more harm than it would do just to cap the tax cut or to defer the tax cut that we had voted for previously. I think it would be better to think in terms of some kind of a tax where everybody who is not a low-income person will pay his part, and have an appropriate arrangement to take care of those who are in a low-income situation.

That generally is my position, and that's how I am going to vote. Thank you.

Senator **DANFORTH**. Well, I generally agree with Senator Long, except for his comment about the third year of the tax cut. But I would rather do it by making some adjustment to the indexing part of what we did; because I think we could do that in the outyears and not have an effect on the recovery.

But it seems to me that the problem with the kind of approach we are into today—not to say that it's not worth doing—is when you start making laundry lists, Congress starts making laundry lists, that just means that one-by-one we are getting every group in the world coming before us saying, "Don't do that to us." And if you do target one group such as home building or real estate, you can really have a disproportionate effect on the group.

I think what we should do is to look at a very broad-based approach and be willing to make some very unpopular decisions.

Dr. Carlson said that "entitlements have to be part of it." I don't think that it is possible to come up with the dollars without the entitlements. I don't want to touch the entitlements. Politically, I almost lost an election on the question of entitlements. I don't want to do that.

And maybe we will decide we don't want to touch the entitlements, and maybe we will decide that we don't want some broad-based tax effort. Maybe that is the decision; but I think that if we are going to make that decision we have to also recognize that the reality of the situation is, therefore we are going to have budget deficits of $150 billion-plus every year—not just 3 or 4 or 5 years, but every year. And the interest on the national debt is going to get higher and higher and higher, and therefore the deficit is going to get evermore out of control.

So I think that your comments are quite right—the reality is, we have to face the entitlement question; the reality is, as Senator Long said, we have to face the broad-based approach on taxes, or else we are not going to come up with the dollars.

Dr. Carlson, I take it that you would be in general agreement with that. I don't know about the tax part.

Dr. **CARLSON**. Yes, sir, especially if the tax increases that you felt were necessary were primarily on consumption and not on investment, because I do think we are an investment-short economy.

Senator **DANFORTH**. Yes.

I think this: That it is not possible to put together a package unless both taxes and spending are in it. You just can't say, "Oh, we're going to do it all by taxes." Even if that were smart economics, you couldn't put together a package without having spending and taxes together.

What is the status of the homebuilding industry now? Is it in great shape with everybody at work and ready to assume another blow from Uncle? [Laughter.]

Mr. **SMITH**. Well, we don't feel we're in great shape. We are a lot better than we were previously, but we still have an awful long ways to go, we still have an awful lot of people to put back to work. And I'm sure you are aware that we've had about a 95-percent cut in programs in housing, and over the last 3 years at a time when we were in the worst recession that our industry has ever encountered.

But we will lead this country out of the recession—I think we are proving that—with the proper tools.

Senator DANFORTH. Well, I just can't imagine that with the shape that the homebuilding industry has been in, and the construction trades have been in for now a period of years, I just can't imagine that one of the targets is going to be this particular sector of the economy.

Mr. SMITH. We feel we've taken our share.

Senator DANFORTH. Gentlemen, I would like to make just one other suggestion to you. I very much appreciate your testimony, and again Senator Dole may have some questions, but the public is going to have to get ahead of its politicians, because we have proven that what we really want to do is to increase spending and cut taxes, and practice the politics of joy. And we think that we are making ourselves popular by doing that.

I think it is very important for people such as yourselves not only to testify before committees of the Congress and state your own positions relating to your own industry, but also try to present the reality of the situation to the American people, because I think it is only after we face up to the facts, only after we face up to the reality, will those of us in political office have the courage to act accordingly.

If the American people honestly believe that all of the problems of the economy can be solved by such things as not increasing congressional pay or fiddling around with the defense budget or getting fraud out of food stamps, and so on and so forth, if they believe that that is the sum total of the problem, then they are never going to be willing to face up to the really hard decisions which we are going to have to make, which will, as Senator Long pointed out, affect virtually everybody in the country.

So I think, really, we have a big job to do of putting the facts out to the public and giving the public an opportunity to get ahead of the politicians.

Dr. CARLSON. Senator, would you have any suggestion of a target of opportunity for the public to focus on, such as maybe a continuing resolution at the end of this fiscal year, or some other, that they could express themselves to the politicians?

Senator DANFORTH. Well, Senator Boren and I made a suggestion. It's getting nowhere, I'm sure, but we are floating the idea, and we are attempting to push it. The idea is this: From 1985 to 1988, for purposes of both taxation and the entitlements, the adjustment for inflation should not be a full Consumer Price Index adjustment but CPI minus 3 percent.

Dr. CARLSON. Very good.

Senator DANFORTH. That will touch almost everybody except the people in the means-tested program, except for the very poor people. It doesn't come up with all of the dollars we need; it comes up with a big chunk. But I think that the message is that all of us are in this together, and that the American people are going to have to be faced with that; they are going to have to be given the opportunity to choose whether or not they want to make a sacrifice.

The problem with nickel-diming it, the problem with coming up with some approach aimed at some little, you know, specific deal in the Tax Code, some little loophole—we should do it; I don't doubt that—the problem with focusing on that is that people say, "Well, I've got the best of all worlds. You know, I don't have to participate in the solution at all. Somebody else can do it." That's the problem with the cap on the tax cut. That's to say, "Hey, we've got a problem. Let's let somebody else solve it." Tax the fellow behind that tree, as Senator Long said. [Laughter.]

And it's not responsible, and it's not true. So the whole point that Senator Boren and I are trying to make is that we are all in this thing.

I bet if you put it to the American people, as J. F. K. tried in his inaugural address, I bet if you really put it to the American people and said, "Are you willing, along with everybody else in the country, to make some sacrifice—not a whole lot, but some sacrifice—because your country is in trouble?" Most people would say, "Yes, we are," because they still believe in their country. But we in politics are so shellshocked, we don't want to ever ask anybody to sacrifice anything. So what do we do? We make up "laundry lists"—laundry lists of other guys who can bear the burden. And in this case one of the names on the laundry list is real estate and homebuilding—you know?—those well-to-do, prosperous, no-problem homebuilders. [Laughter]

Senator **Danforth**. So, I don't know. That's my view of it.

Senator **Long**. Could I just add a word before you wrap this up?

Senator **Danforth**. Yes.

Senator **Long**. I think that Senator Danforth has pretty well drawn a picture of the problem and the direction we are going to have to head toward the answer.

Here we are talking about the Finance Committee being called upon by the Congress to make a recommendation which, in the third year, on an annual basis, would bring in $42 billion a year of additional taxes.

I have a high regard for Senator Metzenbaum, although he and I don't always agree. And in my judgment, for us to try to talk about getting that $42 billion by nickel and diming it, industry by industry. Half of the people in the oil business are out of work right now. How did we get in this economic mess that we have been suffering for for the last 7 years? It all started with that energy disaster. Do you recall that, Dr. Carlson? That's where the whole thing got started. This recession that we are trying to get out of was all triggered by that energy fiasco; wasn't it?

Dr. **Carlson**. Excuse me?

Senator **Long**. This long recession, the longest recession since World War II, was started by that energy disaster that occurred back when Khomeini came to power in Iran.

Dr. **Carlson**. Yes, sir.

Senator **Long**. And prior to that time the biggest mess that we had to contend with was the previous energy crisis. It didn't seem to teach us a thing.

If we want to avoid triggering another 7-year recession with another energy crisis, it just seems to me that we ought to have the oil industry out there working. Half of their employees are out of work now; don't put the other half out of work. Put them to work, just like we are trying to put the homebuilders to work. We need all the energy we can produce. We can't produce enough to meet all our requirements, even if they are all working full time.

So there is a big opportunity that we ought to be exploiting one way or another.

But to raise the $42 billion in taxes, you aren't going to get it by saying that the independent producers seem to have a tax advantage that equates out to $900 million, and then take part of that away. Let's say you take half of that tax advantage from them, you have narrowed your gap by 1 percent, and meanwhile you are setting the stage for another energy disaster like we've had twice already.

To get that kind of money, $42 billion, you are going to have to think in term of taxes that affect just about everybody. If you are just taxing the average American family, you would need $800 for every family in America to raise that kind of money.

So to talk about raising that kind of money by taking a bite out of the housing industry, and then taking a bite out of the shopping centers, and then taking a bite out of an independent oil producer, by the time you got through with all of that you would have about 5 or 10 percent of the amount you need to raise, and meanwhile you might have triggered another recession for the country.

If we are going to do something about the deficits, I think we have got to do something where, as Senator Danforth suggests, all Americans will have to be asked to share the burden.

I would like to ask you this, Dr. Carlson, because I think you have been reading these things more than some of us do: Are you familiar with the recommendations that have been made to us by the Peterson Commission? That is, former Secretary of Commerce Peterson and those five former Secretaries of the Treasury, Mr. Douglas Dillon, Henry Fowler, Mr. Blumenthal, Mr. Simon, and Mr. Connelly. Are you familiar with the recommendations those men have made?

Dr. Carlson. Yes, sir.

Senator Long. Would you give us what the idea of it is?

Dr. Carlson. The idea is that we have to bring the deficits down more energetically than we have in the past, that there has to be a broad-based program, that it should not be anti-investment in the process, and it obviously involves some taxes along with the reduction in the rate of spending. I think it is somewhat similar to both of your expressions here as to what the answer is, and I frankly think that that has to be our solution to get this deficit down, as you have expressed it here, and as the Peterson group has expressed it.

Senator Long. Now, there is a distinguished group. Five of them served as Secretary of the Treasury. All of them are very successful. None of them is asking for any special advantage for the industry of which they are a part today. They are five outstanding men. Three of them served under a Democratic administration; three of them served under a Republican administration. And I don't know where you would find a more responsible group saying, "Here is the kind of thing that you need to be doing."

I know it is easier to tax "the fellow standing behind the tee." But it seems to me that after we get through talking about how to get out of this trap by picking on the timber grower, and then the homebuilder, and then the independent oil and gas producer, and then some other fellow here and there, there are just not that many people standing behind a tree for us to go after that way. So the idea of these invisible taxpayers paying $42 billion a year more, where the average person doesn't pay any part of it, is just out of the question, in my judgment. We are just kidding ourselves if we think we can raise $42 billion where a major impact doesn't fall on every family that is paying taxes in America. And I think you agree with that.

Dr. CARLSON. Yes, sir.

Senator LONG. Do most of you agree with that? For that kind of money, we are going to have to be thinking in terms of impacts across the board, where every American family will have to pay part of it.

Mr. WOODBURY. I certainly agree.

Senator LONG. Do you all tend to agree with that?

Mr. SMITH. Yes, sir.

Senator LONG. Well, that's the way it is looking to me. And I think that those former Secretaries of the Treasury, as well as Mr. Peterson who served as Secretary of Commerce, I think they rendered a service when they suggested that that's the direction we'd better be looking. Cut spending, or we are going to have to put more taxes on the people, unless we are going to put the people of this country so badly in debt that they will never hope to get out of it, where the interest of the national debt will be the largest single item in the whole budget.

Dr. CARLSON. Sir, if you wouldn't mind my turning around the question, inasmuch as we have had these people who have served their country well, and we do listen to them when they make comments, why do you think they have been unsuccessful in penetrating the views of the political leadership of our country in coming up with a solution.

Senator LONG. Well, I think it's the fault of people like you, Dr. Carlson, and you gentlemen here. Each of you is speaking for a major segment of the American economy, particularly a major segment of American business. And I think you people are going to have to rally behind those kind of citizens and give them the kind of support it takes to get the attention of Congress.

Now, they came up here, and on this committee these Senators listened, and I think two of us here agreed with them. We agreed with the general philosophy that they were expressing. But to get that to the attention of the average Member of Congress, at the grassroots level, your associate members are going to have to talk to their Congressmen and talk to their Senators. And if you can, do the job where you can get just the average little homebuilder back home to ask your Senator and Congressman, "Well, how about the suggestion of those five former Secretaries of the Treasury? Doesn't that make sense?"

When they come to speak to a civic club, you know, often the easy way out is to just throw it open to questions. So when they throw that open to questions, I hope that those of you who are represented here will have some association members who will say, "Well, lookee here. Why don't you consider some of those recommendations of those five men who served as Secretary of the Treasury? Three Democrats and two Republicans. But Douglas Dillon was a Republican serving in a Democratic administration; he was a Republican before John Kennedy became President. But if you add Mr. Peterson, that makes three Republicans, three Democrats, all of whom played a very responsible role in administrations during the recent years, all respected even by those on the other side of the aisle. I think you ought to consider the suggestions those men are making, because it looks to me as though they are pointing us in a direction we are going to have to go."

Senator DANFORTH. I would like to just add one other point. I think we have kept you so long, that it's probably torture for you, but just one other suggestion:

The American people have long known that huge deficits are bad. The American people have long known that high national debt is bad. They feel bad, intuitively; people don't have to argue the case. They believe that.

Now they are witnessing an amazing phenomenon in this country, where heretofore conservative politicians are telling them to forget about the size of the deficit.

It is unbelievable to me that members of my party whom I used to believe were conservatives are adopting this exceptionally casual view of the size of the deficit. And maybe one thing that we should do is to try to rekindle—if anything is lost—rekindle that flame of reaction against high deficits.

I really think that the supply-side concept has something to say for it, but, golly, if we are about to reject any kind of tax increase and any kind of package to really get the deficit under control because of some newfangled ideology, I think that's just crazy. Senator Roth used the word "insanity" in his letter. Well, I think the comment is well put, although I don't agree with his letter.

Gentlemen, thank you all very much.

[Whereupon, at 12:46 p.m., the hearing was recessed, to be resumed at 10 a.m., Wednesday, June 29, 1983.]

# ADMINISTRATION'S FISCAL YEAR 1984 BUDGET PROPOSALS—II

---

WEDNESDAY, JUNE 29, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, D.C.*

The committee met, pursuant to notice, at 10:28 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole, Chafee, Durenberger, and Long.

[The prepared statement of Senator Durenberger follows:]

## STATEMENT BY SENATOR DAVE DURENBERGER

At about this time last year, this Committee was faced with the task of raising an additional $100 billion over three years. I managed to do so by instituting many long-needed reforms to the Federal tax code. As the Committee is again faced with the prospect of raising significant amounts of new revenue, the tendency will once again be to look for additional reforms that both produce new revenues and improve the overall Federal system of taxation. And, foremost among the possibilities will be those reforms left over from last year that were seriously considered but left out of the final tax bill.

At the top of most lists of reforms last year was the elimination of the deduction for state and local sales and personal property taxes. This proposal is certain to come under serious scrutiny once again this time around.

So, at the outset, I will state emphatically that any assault on the deductibility of state and local taxes solely as a means of raising more Federal revenue is misdirected and ill-advised. This does not mean, however, that the deduction of state and local taxes should remain exempt from examination as this Committee goes about genuine tax reform.

I think there are three basic questions this Committee should address as it goes about determining the future treatment of state and local taxes in the Federal tax code.

First, is the deduction of state and local taxes an efficient Federal subsidy for state and local governments? I think of efficiency in this context as the amount of benefit realized on the state and local end, compared to the dollar of revenue lost or expended here on the Federal end. When economists look at the revenue value to state and local governments of the Federal government giving tax relief to taxpayers through the deductibility of state and local taxes, they discover this to be a relatively inefficient way to subsidize these governments. It is estimated that for every dollar of Federal revenue foregone because of state-local tax deductibility, state and local governments receive only about 21¢ in the form of increased revenues over what they would have realized in the total absence of deductibility. It is further estimated that if the deduction is not totally eliminated but is limited in a careful manner, for each dollar in deductions taken away, state and local governments will realize a decrease in revenues equal only to about a dime.

The second question this Committee should address is suggested by the answer to the first: Is it possible to limit the deductibility of state and local taxes and replace this indirect subsidy with a more efficient subsidy? The answer to this question is a resounding YES! The most efficient of all direct Federal assistance to state and local governments is a program this Committee will consider this afternoon for reauthorization: General Revenue Sharing. It is estimated that for every dollar Congress appropriates for revenue sharing, 99¢ finds its way into the hands of state and local officials, with only 1¢ consumed for administrative costs.

Limiting the deductibility of state and local taxes and returning the increased Federal revenues to state governments through a new state revenue sharing program will produce enormous efficiencies. Instead of 10 to 20¢ of every Federal dollar finding its way back to state and local officials, 99¢ on the dollar would be available.

This then leads to the third essential question that must be addressed: What is the best way to limit the deductibility of state and local taxes? To answer this let me begin with the worst possible approach—selectively repealing the deductibility of a single tax such as the sales tax. Nationwide in 1980, sales tax accounted for 16 percent of all deductions for state and local taxes, but this measure ranged from less than one percent in Oregon to 46 percent in Louisiana. If sales tax deductibility were repealed, the additional Federal revenues would come mainly from residents of states that relied on the sales tax as an important revenue source, and little from residents of states that levied no sales tax. Furthermore, the Federal government, by this action, would be encouraging states to shift reliance off the nondeductible sales tax onto other taxes that remain deductible, such as the real property tax.

A major issue in designing a limit on deductibility is how much it will cost state and local governments in lost revenues. By this standard, selective repeal of the sales tax is also an undesirable approach. Of the several major approaches I have examined, selective repeal of the sales tax would produce the largest revenue losses to state and local governments.

I have looked carefully at possible ways to limit deductibility and have come to the conclusion that the best way to treat the four remaining taxes eligible for deduction—income, sales, personal property and real property—is to combine them into one pool and to place a floor on the total amount that may be deducted. This floor should be expressed as a fixed percentage of a taxpayer's adjusted gross income to avoid a regressive effect. Only taxes in excess of the floor amount would remain eligible for deduction, while taxes paid up to the floor would now be subject to the federal income tax.

This approach has several desirable attributes. It is not regressive. It does not skew state and local tax decisions in favor of or against any one particular tax. It raises revenues more uniformly among all states. And, it produces the least loss in state and local own-source revenues. The Congressional Research Service has estimated that for each dollar collected by the Federal government through this limitation, state and local governments can expect to lose on the order of 10 cents in own-source revenues. In other words, by not spending an additional Federal dollar, the efficiency of subsidizing state and local governments would improve ten-fold if the dollars raised through this limitation were returned directly to states as revenue sharing.

Mr. Chairman, this is genuine tax reform. It improves the Federal income tax by broadening its base. It limits a loophole from which only 30 percent of all Federal tax returns benefit. But, at the same time, it does not neglect the profound policy implications such a change holds. And most importantly, it does not merely seek increased Federal revenues while hiding behind the rhetoric of tax reform.

Before I submit to your questions, let me introduce Miss Nonna Noto, a senior analyst with the Congressional Research Service, who with her colleague, Dennis Zimmerman, just completed a comprehensive report on this question of state and local tax deductibility for the Governmental Affairs Committee. I have a written statement that I would like to submit on their behalf, and Miss Noto will be available to back me up if there are any specific questions regarding the CRS report.

Thank you, Mr. Chairman.

Congressional Research Service
The Library of Congress

Washington, D.C. 20540

# LIMITING STATE-LOCAL TAX DEDUCTIBILITY: AN ANALYSIS OF THE ECONOMIC EFFECTS*

by

Nonna A. Noto and Dennis Zimmerman
Specialists in Public Finance
Congressional Research Service

Statement Submitted to

Senate Committee on Governmental Affairs
Subcommittee on Intergovernmental Relations

for

Hearings on Tax Expenditures
U.S. Senate Committee on Finance

June 29, 1983

---

*This statement is based on a recently completed study of limiting State-local tax deductibility prepared by the Congressional Research Service at the request of the Senate Committee on Governmental Affairs, Subcommittee on Intergovernmental Relations. For the full report, see: U.S. Library of Congress. Congressional Research Service. Limiting State-Local Tax Deductibility in Exchange for Increased General Revenue Sharing: An Analysis of the Economic Effects [by] Nonna A. Noto and Dennis Zimmerman. Washington, June 2, 1983. 92 p.

The provision permitting the deduction of taxes paid to State and local governments from the Federal individual income tax base is under serious scrutiny. The Revenue Acts of 1964 and 1978 established legislative precedents for curbing the deductibility of fees and taxes paid to State and local governments by eliminating the deductibility of motor-vehicle license fees and of excise taxes, including those on gasoline. The repeal of sales and personal property tax deductibility was considered in deliberations over the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Given the continuing fiscal pressures on the Federal Government, it is useful to devote attention to the choice among four major types of deductibility-limitation proposals that surfaced in the discussions surrounding TEFRA. One proposal is to completely eliminate the deductibility of the general sales tax. A second proposal would place a fixed dollar floor on all eligible State-local tax deductions, estimated by the Joint Committee on Taxation at $375 for single returns and $750 for joint returns. Only State-local tax payments above that floor would be deductible. A third proposal would also set a floor, but one that varied with income, estimated by the Joint Committee on Taxation at one percent of adjusted gross income. A fourth proposal would set a ceiling on deductions, estimated by CRS at 6.5 percent of adjusted gross income. State-local taxes in excess of that ceiling amount would no longer be deductible. All four proposals are designed to raise approximately $5 billion in additional Federal revenues in fiscal year 1985.

The historical reason for allowing deductibility was not so much to provide a subsidy to State and local governments, but more to avoid "taxing a tax," that is, to avoid taxing individuals on income used to make payments over which taxpayers were felt to have no discretionary control. Deductibility helped avoid confiscatory cumulative Federal-State-local income tax rates during the period when the top Federal marginal tax rates were very high (they peaked at 90 percent in 1944-45).

But even at the outset of the Federal income tax in 1913, user charges and special assessments were not deductible because they were considered to be payments for specifc services. Over time, some general-purpose taxes also have had their deductibility removed, for a variety of reasons. For example, it was considered inappropriate that, simply because of small differences in their legal specification, taxes levied by some States were considered deductible, while taxes paid to other States, although essentially the same in their economic incidence, were not deductible. Some, such as gasoline excise taxes and motor-vehicle license fees, were considered to be user fees. Others, such as alcohol and cigarette excise taxes, were sumptuary taxes designed in part to discourage consumption, and deductibility was viewed as counterproductive in this regard. And for some of these same taxes, it was considered administratively unmanageable for the IRS to determine a taxpayer's legitimate deductions.

Recently, State-local tax deductibility has come under criticism in response to a growing perception that the services provided by some State-local governments have expanded beyond providing just basic public services and that deductibility is in essence subsidizing private consumption through the public sector. If this is the case, it is not clear that all general-purpose State-local tax payments merit deductibility.

Several possible effects upon State and local government fiscal choices should be considered in the Federal decision to limit deductibility. Limiting deductibility may raise the price of public goods relative to the price of private goods, thereby causing some reduction in the level of State and local spending financed by their own tax sources. Allowing deductibility for some taxes but not others may bias the choice among State-local revenue sources away from nondeductible taxes. Limiting deductibility may also discourage State and local governments from using a more progressive tax system. Finally, limiting deductibility would reduce the Federal buffer on effective tax differentials among State-local jurisdictions.

While the four alternative deductibility-limitation approaches are comparable in the revenue they are expected to yield to the Federal Government, they are quite different in their implications for who would be paying those higher Federal taxes and for State and local government finances. In terms of income-distributional effects, the least progressive proposal would be the fixed dollar floor, and the most progressive would be the percentage-of-AGI floor. When viewed on a nationwide basis, the proposals to eliminate the deductibility of the sales tax or to set a ceiling on all State-local taxes both appear moderately progressive. However, because of substantial differences among State-local tax systems, the effects of these two alternatives are expected to be distributed quite unevenly among taxpayers in different States.

Nationwide in 1980, sales taxes accounted for 16 percent of all deductions for State and local taxes, but this measure ranged from less than one percent in Oregon to 46 percent in Louisiana. If sales tax deductibility were repealed, the additional Federal revenues would come mainly from residents of States that relied on the sales tax as an important revenue source, and little from residents of States that levied no sales tax.

Nationwide in 1980, deductions for State and local taxes were 7.4 percent of estimated AGI for itemizers, but this ranged from 2.7 percent in Wyoming to 12.2 percent in New York. Half the States were above the proposed ceiling of

6.5 percent of AGI, and half were below. Thus, the ceiling approach would be expected to raise the Federal tax liability of most itemizers in high-tax States, but affect proportionately fewer itemizers in low-tax States. These considerations point to setting a floor that lies below the average tax burden in even the lowest-tax State as the alternative that appears to spread the burden of higher Federal taxes most even-handedly among taxpayers in different States.

A question of special concern to State and local governments is how much limiting this deduction would reduce peoples' willingness to pay State and local taxes. A critical distinction is whether a particular limitation proposal would be perceived by Federal tax itemizers as simply reducing their after-tax incomes, or whether it would also be perceived as raising the relative price of State and local services. The distinction is important to State and local governments because studies estimate that the decrease in spending on State-local activities associated with a one dollar decrease in after-tax income is approximately 10 cents if there is only an income effect, but 20.5 cents—twice as large—if there is a price effect.

To give a more specific numerical example, for an itemizer in a 34 percent marginal tax bracket, $1.00 in deductible State and local taxes in effect costs only $.66 net of Federal tax. If deductions were limited by $100, the itemizer would see Federal tax liability increase by $34 and after-tax income decrease by $34. If the limitation were designed so that a change in State-local taxes would still be reflected in a change in deductions, then the net price of a dollar State-local taxes would remain unchanged at $.66. If, however, the limitation were designed so that a change in State-local taxes would not change eligible deductions, then the net price of the last dollar of State-local taxes would rise from $.66 to $1.00, generating a price effect. A $34 decrease in after-tax income implies a decrease in willingness to pay State and local taxes of $3.40 under an income effect of .10, and $6.97 under a price effect of .205.

There is likely to be only an income effect if deductions are limited from the bottom--that is, by setting a floor low enough to leave most itemizers with some State-local taxes still eligible for deductions, so that the last dollars of an itemizer's State-local taxes would be subsidized at the itemizer's Federal marginal tax rate. In contrast, there is likely to be a price effect if deductions are limited from the top by placing a ceiling on deductions, so that the last dollars of an itemizer's State-local taxes would not be cushioned by a reduction in Federal tax liability. If sales tax deductibility were repealed, a price effect would be associated with efforts to finance State-local spending through sales taxes.

As a result of the price effect and the differing reliance on the sales tax among the States, the proposal to eliminate the deductibility of general sales taxes is expected to generate both a greater aggregate reduction in State-local tax revenues and greater variability among the States than the percent of AGI floor approach. CRS estimates that as of 1980, imposing a floor at one percent of AGI would have raised $3.0 billion in Federal revenues. Assuming an income effect of 10 percent, this would generate a reduction of approximately $300 million or .13 percent of total State-local tax revenues, ranging from .06 percent to .17 percent among the States.

In comparison, eliminating the deductibility of the sales tax would have raised $3.5 billion in Federal revenues in 1980. Assuming a price effect of 20.5 percent implies a potential loss of $720 million or .32 percent of total State-local tax revenues, ranging from .01 percent to .49 percent among the States.

In sum, if the Congress decides to limit the deductibility of State and local taxes under the individual income tax, it can choose among several methods. While any of the four approaches analyzed in the CRS report can increase Federal revenues by an equivalent amount, each method is likely to have different economic effects. Among the four proposals, the fixed dollar floor is least progressive and the percent-of-AGI floor most progressive. The proposals to repeal the deductibility of the sales tax or to place a ceiling as a percent of AGI would be more uneven in their effects on itemizers in separate States because of substantial differences in State-local tax structures. Furthermore, the sales tax and ceiling approaches are likely to have a more negative effect on State-local ability to collect taxes than a floor approach, because they are likely to be perceived as raising the relative price of State and local taxes, in addition to reducing itemizers' income after Federal taxes.

Senator DURENBERGER. The hearing will come to order. We are going to start the hearing off not with the Senator from Minnesota, because he is the only one here, so he is going to preside.

We are going to start with a panel consisting of Ramsey D. Potts, Esq., on behalf of the National Committee on Small Issue Industrial Development Bonds; Donald C. Wegmiller, president, Health Central System, Minneapolis, on behalf of the American Hospital Association; and Ronald Bean, president, Council of Pollution Control Financing Agencies.

If those three people are present, would you come on up? I will avoid saying anything about Mr. Potts or Mr. Bean, but I have to say something for the record about Don Wegmiller. I have known him for about 15 years, and I have learned a few things about him. He is smart, he is honest, and he is frank, which makes him a good friend and a good advisor; but it can also get him into trouble. Don was quoted last year as saying that as many as 1,000 hospitals could close in the next decade, and that sent Alex McMahon right up a tree. Alex said, "I am not one who subscribes to the erroneous press reports that 1,000 hospitals will close. None of them will close."

About my Peer Review Improvement Act, Don Wegmiller once wrote, "The constituency for this bill is unknown to me. The benefits of the bill are clearly a mystery." Needless to say, the bill passed. [Laughter.]

It is this kind of leadership that has made the Health Central System one of the most progressive in the Nation. Total expenses of Health Central hospitals increased only 4.1 percent in 1982, compared to the national average of 16.8 percent. Expense per admission increased 7.8 percent versus the national average of 16.6 percent. As Don has demonstrated, it is possible to manage effectively in times of a tight economy.

As you can see, it's with obvious pleasure and enthusiasm that I welcome Don Wegmiller to this panel. But we are going to start with Mr. Potts, and then Mr. Wegmiller, and then Mr. Bean.

## STATEMENT OF RAMSAY D. POTTS, ESQ., ON BEHALF OF THE NATIONAL COMMITTEE ON SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS, WASHINGTON, D.C.

Mr. POTTS. Mr. Chairman, I hope you will let me finish my summary. I was told that I would have 3 minutes; I hope I can do it within that time, but I will go quickly.

First, the IDB reforms enacted last year in TEFRA placed restrictions on activities that could be financed with IDB's, denied Accelerated Cost Recovery to plant and equipment, mandated public hearings, and provided for detailed reports to the U.S. Treasury Department. You should wait at least another year, Mr. Chairman, to assess the impact of these changes before placing further restrictions on the program. Any further restrictions would almost surely kill the program entirely, or make it only marginally useful.

Second, the IDB program is considered by 48 States that use it to be economically productive and highly useful in creating and retaining jobs and stimulating depressed local economies. I give examples in my prepared testimony of the beneficial effects of the program in Minnesota, Michigan, Connecticut, New York, Louisiana, Texas, Rhode Island, New Jersey, Missouri, Massachusetts, and Mississippi, and I could give examples for the rest of the 48 States that use IDB financing.

Third, the cost of capital, Mr. Chairman, is key to decisions by firms of all sizes, whether they be small, medium, or large, to modernize plant and equipment and is the key to being competitive. Many Japanese companies in export trade receive interest-free loans from their government. Other companies receive loans from the Ministry of International Trade and Industry at 5.5 and 6.5 percent. Consider the difference in cost of capital over 20 years on a $200 million loan at 15 percent as compared with 5 percent. The difference is $400 million. Then consider the pricing advantage a Japanese company has with that difference.

I recommend, Mr. Chairman, that your committee address this issue and determine a way for American companies in competition with foreign competitors to receive low interest rate loans to modernize their plant and equipment and thus be cost and price competitive. This cost of capital factor is more important than the cost of labor.

Some of the proposals being made would eliminate manufacturing and industrial firms and high-tech and growth firms from the IDB program. We think this would be a grave mistake.

Fourth, I question the validity of the revenue loss figures advanced by Treasury. They are based on the assumption that purchasers of IDB's would purchase taxable bonds or other taxable instruments if there were no IDB's available. This is a false assumption because such purchasers would simply seek other tax-free investments.

Finally, Mr. Chairman, I believe the impact of IDB's on general obligation and revenue bond interest rates has been much exaggerated. I refer to a study by Henry Kaufman in an analysis he has made, and studies by Norman Ture and Roger Kormendi for the national committee, which I represent.

In conclusion, Mr. Chairman, you may not get any revenue from placing further restrictions on IDB's, and at most very little, and as long as interest rates remain high you would do grave damage to the economies of the States and local communities by placing further restrictions on this financing.

Thank you, Mr. Chairman.

Senator DURENBERGER. Thank you very much, Mr. Potts. You did a good job of summarizing.

Mr. POTTS. Thank you.

Senator DURENBERGER. I might mention that, without observable objection, all of your printed statements will be made a part of the record.

Mr. POTTS. Mr. Chairman, I might say that I do represent a company from Minnesota, Rosemount, which I think you know about, one of the fine companies in Minnesota and in the country.

Senator DURENBERGER. I do.

Mr. POTTS. They are able to compete in international competition, mainly because in some instances they have been able to use IDB financing.

Senator DURENBERGER. They are not one of the companies that is moving to South Dakota?

Mr. POTTS. I think they like it in Minnesota, and they intend to stay there and continue to build up their facilities there, especially their research and development facility.

Senator DURENBERGER. Thank you very much.

[The prepared statement of Ramsay D. Potts follows:]

### STATEMENT OF RAMSEY D. POTTS, COUNSEL TO THE NATIONAL COMMITTEE ON SMALL ISSUE INDUSTRIAL DEVELOPMENT BONDS

Mr. Chairman and members of the Committee, my name is Ramsey D. Potts. I am counsel to the National Committee on Small Issue Industrial Development Bonds. I am also a senior partner in the Washington law firm of Shaw, Pittman, Potts & Trowbridge. The organizations I represent appreciate this opportunity to present the views of the National Committee on Small Issue Industrial Development Bonds (small issue IDB's). The National Committee on Small Issue Industrial Development Bonds is a non-profit membership organization dedicated to preserving and increasing the effectiveness of small issue industrial development bonds as mechanisms for capital formation and job creation. The Committee currently has 74 members, principally user corporations, but also state economic development organizations, investment bankers and other supporting individuals and groups. A list of members of the National Committee on Small Issue Industrial Development Bonds is attached (Attachment A).

Our Committee has been actively involved in matters affecting small issue IDB's since 1978 when we were instrumental in having the limit in small issue IDB's subject to the capital expenditure rule raised from $5 million to $10 million. For the last five years, our members and our organization have worked closely with state and local economic development authorities to understand their needs and their problems. In order to develop factual material about IDB financing, the National Committee has commissioned two studies on small issue IDB's. The first, "The Economic and Federal Revenue Effects of Changes in the Small Issue Industrial Development Bond Provisions" by Dr. Norman B. Ture, former Undersecretary of the Treasury for Tax and Economic Affairs, was published in 1980. The second, on "The Federal Revenue Losses from Industrial Development Bonds" by Roger C. Kormendi and Thomas T. Nagle of the University of Chicago, was published in 1981. Dr Ture's Study was submitted to this Committee at a hearing on Small Issue Industrial Development Bonds on August 1, 1980. Dr. Kormendi testified in person at that hearing and commented extensively on the material in his Study cited above. The findings of these studies are just as valid today as they were when published. Copies of these studies are available from the National Committee.

### SPECULATIVE REVENUE LOSS

The National Committee recognizes that there are different views regarding the impact on the Federal revenue of small issue IDB's depending on the formula or approach used. The dynamic or feed-back approach advocated by Dr. Ture in the study he did for the National Committee, concludes that the Federal Treasury gains net revenues from the IDB program. Doctors Kormendi and Nagle show foregone federal tax revenues in the order of $4 to $6 million dollars for each billion dollars of new IDB's when interest rates are in the range of 10 to 14 percent. These estimates contrast sharply with the Treasury's and CBO's estimates of $30 to $40 million for each billion dollars of bonds. In any event, the dollar figures of revenues loss from small issue IDB's advanced by critics of the program are entirely speculative and small in comparison with the revenue losses from other more recently-enacted tax provisions, including the tax leasing provisions and the cuts in personal income tax rate.

Treasury's figures on revenue loss are based on the assumption that every individual investor or institution which currently holds a tax-exempt IDB would transfer that investment to a taxable bond if IDB's were not available. That assumption will not withstand analysis. Every independent study has shown that investors who hold a tax-exempt investment shift to another tax-exempt or tax-sheltered invesment if the first tax-exempt investment ceases to be available. There is a range of tax-exempt or tax-sheltered investments available to investors and they continue to purchase such investments in order to reduce their taxable income.

IDB's have been blamed for helping to force up the interest rates of all other tax-exempt issues. Pressure on the municipal bond market, however, is coming from many sources, most of which have a far greater impact on the interest rates of general obligation and revenue bonds than the presence of small issue industrial bonds. For example, U.S. Government borrowings in the range of $85 billion in net new funds in 1982 overshadows the impact of all other parties seeking credit.

The weakening of credit of municipal issuers has also affected the interest rates at which new issues are offererd. In the last few years, the downgrading of municipal issuers has doubled and the upgradings have declined to less than half of their 1973–1978 average. Municipalities are facing increased budgetary needs and reduced Federal grants which put additional pressure on their credit ratings and put upward pressure on their interest rates.

### BENEFITS OF IDB'S

The question, however, of some possible small revenue loss is not nearly as important as a proper appreciation of the benefits of IDB financing.

Small issue IDB's are now being used to finance facilities in 48 states from Alaska to Florida and from Maine to California. IDB's provide access to capital, which makes possible the much-needed investment in plant and equipment and creates new jobs or retains existing jobs. With unemployment still at 10 percent, communities need IDB's to create or retain jobs. Furthermore, the location or retention of an IDB-financed major facility in a community frequently serves as an anchor and creates a ripple effect, attracting other smaller firms, creating service jobs, increasing the local tax revenues and encouraging further economic development.

Unemployment continues to be severe in certain industries and geographic areas which have used IDB's successfully for the creation and retention of jobs. The effectiveness of IDB financing in creating jobs has been demonstrated by the following information provided to us by the States. For example, Michigan Job Development Authority shows 3,793 jobs created or retained with the issuance of $59 million of bonds in the period from 1979 to 1981. The Connecticut Development Authority reports that between 1973 and 1982, it approved more than $1.3 billion in capital financing for about 1,000 companies, which has helped to secure approximately 70,000 existing jobs and has assisted in the creation of another 44,000 new jobs. The New York State Industrial Development Agency reports 103,707 new or saved jobs through the issuance of $1.9 billion of bonds for 966 projects in the period from 1970 to 1981.

Louisiana estimates that it has created or anticipates the creation of 9,667 permanent jobs and 15,999 temporary jobs in connection with IDB projects financed with IDB's from 1979 to 1981. In four years, Massachusetts has created 58,000 new permanent jobs through the use of IDB financing. Texas in 1981 approved 242 IDB issues which are estimated to create 18,172 jobs. Minnesota reports that 23,000 jobs were or will be created by IDB's approved in 1981. Rhode Island estimates that IDB facilities created 1,781 jobs in 1981. New Jersey reports that 65,000 persons are currently employed in permanent jobs that have been created by IDB financed facilities since 1974. For 1981, New Jersey estimates that 13,336 new permanent jobs and 11,182 construction jobs were created from the IDB financed facilities. St. Louis County Industrial Development Authority has issued 98 bonds since its inception in 1979 for facilities which have created or will create 4,800 jobs in St. Louis County. The New York Times devoted half a page on June 6 to the success story of Springfield, Massachusetts, a city that has received $38 million in IDB financing and has been a model for urban renewal. As a result, unemployment has been held below 7 percent.

Mississippi, the first state to use an IDB program, has continued to use it almost entirely for industrial purposes. Like the other states, Mississippi has no prohibitions regarding the size of a company that may use IDB financing. Over a 40-year span, Mississippi has used IDB financing to build plants for at least 55 corporations among the Fortune 500 industrial corporations and credits its IDB program as vital in its development of industrial facilities and industrial jobs in the State.

### IDB REFORMS ENACTED LAST YEAR SHOULD BE GIVEN TIME TO WORK

The National Committee recognizes that there has been publicity about and criticism of aspects of the small issue program. The Committee believes, however, that the IDB reforms enacted in the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") eliminated the abuses and reformed the programs. Controversial uses of small issue IDB's have been prohibited. New requirements of recordkeeping and public approval have been imposed. Additional limitations on IDB's are unwarranted at this time when bond issuers and users have not had sufficient time to evaluate the changes enacted less than one year ago in TEFRA. Communities and states continue to need flexible economic development tools to deal with high unemployment and high interest rates.

Proposed changes in current law that would require lengthy recovery periods for assets financed by IDB's were rejected by the Congress last year and are counterproductive to the Administration's goal of economic recovery. Assets financed by IDB's already have to be depreciated using the staight-line method, rather than the 150-percent rate available to assets financed by other methods. To extend the recovery periods would hurt the firms and industries that are in greatest need of IDB financing: growth companies, new companies, and companies that are not currently showing high rates of return, because for these firms and others the initial cost of the capital is the critical factor. IDB financing reduces the initial cost of the financing and spurs the modernization of plant and equipment now rather than at some future date. Businessmen continue to be concerned about the persistent high interest rates which contributed to the poor economic climate of the last two years, prevented investment, created unemployment and reduced output. They have delayed investment decisions because of interest costs, which once incurred, unlike some operating costs, cannot be eliminated or curtailed during periods of economic slowdown. Until interest rates are substantially reduced, IDB financing is one of the few ways business can expect to undertake profitable new investments in plant and equipment.

Any further limitations on the use of small issue IDB's by medium and large-sized businesses are also counterproductive to the nation's economic recovery because:

(1) No state at present excludes medium or large-sized businesses from its IDB program. Indeed, the states and local governments want to retain the right to decide when and where they want medium and large-sized businesses to locate in their communities since it is these firms that serve as a magnet for attracting other firms, generate increased tax revenues and generally are stable and dependable members of the community. Moreover, the arrival or retention of a medium or large-sized firm is a catalyst for economic recovery because it creates a ripple effect of additional jobs, services and investment in the community. The state and local governments are facing substantial cuts in federal assistance, decreased tax revenues, and increased transfer payments. They need IDB's now more than ever to provide economic development and to replace the programs and services that have been terminated by the Administration's budget cuts.

(2) Medium and large-sized businesses face the same problem of the cost of capital that all businesses face, and have postponed investment and reduced employment as they are squeezed by the unfavorable economic climate. When considering the construction or expansion of a facility, large companies, just like small ones must

evaluate the costs and potential returns before an investment can be made. In order to be approved, the project must pass the "hurdle rate" for return on investment. At today's interest rates projects of even the largest companies often do not exceed the hurdle rate if they must be financed at market rates. Eliminating the use of IDB's by medium and large-sized companies will reduce capital investments as projects are delayed or abandoned.

(3) Elimination of medium and large-sized businesses from the IDB program would discriminate against manufacturing and industrial firms. These are the firms that have major capital expenditures and that have been most affected by the recent interest rate-caused recession.

(4) One of the proposals that would further restrict IDB's defines large business as one that has capital expenditures in excess of $20 million during the three years preceding the issuance of the IDB. This cap on worldwide capital expenditures would affect many small firms, particularly high technology firms. These firms operate in a highly competitive, rapidly evolving industry in which equipment and products must be updated constantly. Although many of these firms are small, they frequently have worldwide capital expenditures in excess of $20 million in a three-year period, and they have the potential to grow rapidly. The $20 million limit on capital expenditures would discriminate against the most productive uses of IDB's for high technology and manufacturing exports in which the United States remains, for the time being, the world leader. The United States position, however, is being eroded in these fields as it has been in such industries as automobiles, steel, cameras, televisions and radios. The present $10 million limit on the bonds issued and on the capital expenditures within a six-year period already imposes severe restrictions on the size of facilities financed with IDB's. It should be remembered that, if the 1968 limits had kept pace with inflation, the $5 million limit enacted in 1968 and the $10 million enacted in 1978 would be $15 million today. This Committee should legislate to raise the limit to $15 million rather than impose any additional restrictions.

(5) One proposal being advanced would limit corporations to $20 million in outstanding small issue IDB's at any time, but this proposal is counterproductive since it would also eliminate corporations of all sizes, if a firm had financed several facilities with small issue IDB's. It would also remove from the states and local governments the authority to choose what investment or economic development mix they find in their best interest.

## FOREIGN TRADE AND COMPETITION

Favorable interest rates for borrowing to finance new plant and equipment are essential if United States firms are to compete in the domestic and international markets.

(1) The Japanese use preferential interest-rate financing. In fact, they use interest-free loans to encourage certain export-related priority industries, in conjunction with a rapid depreciation schedule to encourge investment. Loans made for technology projects by the Ministry of International Trade and Industry ("MITI") bear no interest. Loans made by the Japanese Development Bank ("JDB") bear a preferential interest rate. Furthermore, the discount rate of the Central Bank of Japan is only 5.5 percent. Savings are encouraged by making the annual interest on the first $3 million yen deposited in the Postal Savings System tax-free for each depositor. In addition, the annual tax-exempt interest rate on these savings is 6.25 percent, which is the same rate as the taxable interest earned on time deposits at commercial banks.

(2) Because of these favorable Japanese interest rates, American firms which have to borrow money at higher rates have great difficulty in producing a competitively-priced product. As a result American firms are increasingly losing out in both the international and the domestic markets to Japanese firms and to other foreign firms which can obtain capital at a lower cost. Some analysts have concluded that the astonishingly lower capital costs of Japanese companies as compared with capital costs of U.S. competitors is even more significant than loser Japanese labor costs.

## CONCLUSION

Proposals that would prevent medium and large-sized businesses and growth industries from using small issue IDB financing and proposals that would extend the depreciation recovery period for assets financed by IDB's, will have a damaging economic impact on the communities that seek to attract industry, on the jobs created or retained by IDB financing, and on the competitive position of United States firms against Japanese and other foreign firms. Moreover, the damaging economic impact will far outweigh any estimated revenue gains from the elimination of the use of IDB's by medium and large-sized businesses.

The economy is going through a period of uncertain recovery in which high interest rates are still a concern. Competition for foreign manufacturers is eroding the position of United States industry in both international and domestic markets in an ever-increasing number of product lines. In addition, with the Administration cutting back on many programs and services provided to states, cities and local communities, IDB programs remain one of the few financing tools available for states, cities and local communities. The National Committee is convinced that this is the wrong time to be imposing additional restrictions on small issue IDB's, when the TEFRA reforms have been so recently put into effect and cannot be adequatly evaluated until more time has passed. Moreover, the National Committee's studies prove that concern over small issue IDB's has been blown out of all proportion to the estimated revenue loss from small issue IDB's. The IDB programs are productive, popular and economically beneficial programs.

Additional restictions are unwarranted at this time. Indeed, what this Committee should consider is some mechanism or program that would make low-interest-rate loans available to American industry for modernizing plant and equipment regardless of the size of the plant or the amount of the investment.

## STATEMENT OF DONALD C. WEGMILLER, PRESIDENT, HEALTH CENTRAL SYSTEM, MINNEAPOLIS, MINN., ON BEHALF OF THE AMERICAN HOSPITAL ASSOCIATION, WASHINGTON, D.C.

Senator **DURENBERGER**. Mr. Wegmiller. There is no time to respond to the introduction. Stick to your prepared comments.

Mr. **WEGMILLER**. Thank you, Mr. Chairman. I will pass over the introduction, thanking you for the kind words.

I am here this morning as a member of the Board of Trustees of the American Hospital Association and, as requested, will try to briefly summarize our views and request that our full statement be included for the record.

Senator **DURENBERGER**. It will be.

Mr. **WEGMILLER**. We understand this committee's important responsibility to examine tax expenditures closely as part of the overall effort to control the allocation of Federal dollars. Federal resources and commitment, whether through direct grants, appropriations, reimbursement for services, or through certain tax policies, all are important factors in the financing of health care.

One important, and particularly important, tax expenditure in the health area that we strongly support and we also feel serves important public and social purposes is the exclusion from taxation of interest on tax-exempt bonds for nonprofit hospitals. Tax-exempt financing is vitally important in minimizing the cost of capital projects. For most nonprofit hospitals it is the primary financing mechanism available for providing resources for capital projects that are absolutely essential in order to maintain our hospitals' infrastructure throughout this Nation in a rapidly changing technological and medical environment.

It is becoming increasingly clear that one of the critical issues we face in the hospital field is the substantial capital requirements needed to insure that hospitals are able to continue delivering high quality health care services. In testimony before the House Ways and Means Committee a few weeks ago, Assistant Treasury Secretary John Chapoton stated that one approach that might be considered to control the volume of tax-exempt financing would be to impose State volume limits. This option was also suggested by the

Congressional Budget Office. We would like to express that we believe such an approach is arbitrary, probably unworkable, unfair, and would certainly deny nonprofit hospitals access to much needed capital.

Over the past 30 years we have witnessed some basic shifts in the sources and uses of hospital capital, and hospitals have become increasingly reliant upon debt financing, particularly the tax-exempt bond market, shifting away from philanthropy and Government grants.

In addition, the demand for capital will continue to grow as facilities constructed in the fifties and sixties, under Hill-Burton programs and others, become outmoded and need renovation and replacement.

The vast majority of hospital capital projects are undertaken to replace or renovate facilities and equipment. They are legitimate, necessary projects. They require capital, but they add no new beds to the existing health care delivery system.

Mr. Chairman, in conclusion, let me briefly state four principal reasons why tax-exempt bonds are very important to nonprofit hospitals:

First: The medicare-medicaid impact. Since the Federal Government pays for about 40 percent of all hospital care, it obviously has an interest in the cost of capital used to finance that care. If hospitals are forced to enter the taxable bond market to finance capital projects through commercial lending sources, the additional costs of hospital care will be significant, will ultimately be absorbed by medicare, medicaid, and other payors.

Second: Reduced cost. At a time when health care providers, consumers, Congress, Federal Government, are most sensitive to restraining the increase in health care cost, financing—tax-exempt—is an important contributor.

Third: The impact on financially weak hospitals. While some nonprofit hospitals may be financially healthy, able to use other debt financing options; financially weak, they will generally be unable to use those alternatives. These are the ones providing most of the free care and charity care in this country.

And most importantly, and fourth, we strongly believe that private nonprofit hospitals serve an unquestionable public purpose in providing high-quality health care services to communities.

Mr. Chairman, that concludes my oral statement. Again, I appreciate the opportunity to appear before the committee and would be pleased to answer any questions. Thank you very much.

[The prepared statement of Donald C. Wegmiller follows:]

## STATEMENT OF THE AMERICAN HOSPITAL ASSOCIATION

Mr. Chairman, I am Donald C. Wegmiller, President of the Health Central System in Minneapolis, Minnesota, and a member of the Board of Trustees of the American Hospital Association (AHA). I am here representing the AHA and its 6,300 member hospitals and health care institutions, as well as more than 35,000 personal members. We are pleased to have this opportunity to present our views on tax expenditures.

We understand this committee's important responsibility to examine tax expenditures very closely as part of the overall effort to control the allocation of federal dollars. Federal resources and commitment, whether through direct grants, appropriations, reimbursement for services, or through certain tax policies, all are important factors in the financing of health care. One particular tax expenditure in the health area that we strongly support, and we also feel serves important public and social purposes, is the exclusion from taxation of interest on tax-exempt bonds for nonprofit hospitals.

Tax-exempt financing is vitally important in minimizing the cost of capital projects. For most nonprofit hospitals, it is the primary financing mechanism available for providing resources for capital projects that are absolutely essential in order to maintain our nation's hospital infrastructure in a rapidly changing technological and medical environment.

It is becoming increasingly clear that one of the most critical issues that we face in the hospital field is the substantial capital requirements needed to ensure that hospitals are able to continue delivering high quality health care services.

In testimony before the House Ways and Means Committee on June 15, 1983, Assistant Treasury Secretary John Chapoton stated that one approach that might be considered to control the volume of tax-exempt financing would be to impose state volume limits. This option was also suggested by the Congressional Budget Office. We feel that such an approach is arbitrary, unfair, unworkable, and would deny nonprofit hospitals access to much needed capital.

My statement will describe trends in tax-exempt hospital financing, explain the reasons for increased use of tax-exempt bonds, and describe the importance of this financing mechanism to nonprofit hospitals.

## TRENDS

Over the past 30 years we have witnessed several basic shifts in the sources and uses of hospital capital. Hospitals have become increasingly more reliant upon debt financing, particularly the tax-exempt bond market, shifting away from philanthropy and government grants. Changes in the economy and in health benefit coverage, as well as specific legislative and regulatory actions, have also influenced the direction of capital financing. In addition, the demand for capital will continue to grow as facilities constructed early in the 1950s and 1960s become outmoded and need renovation and replacement. The health care industry will be continually challenged to develop new sources of capital funding if hospitals are to maintain the facilities and equipment necessary in delivering health care services.

### *Source of capital*

Between 1975 and 1981 alone, reliance on government grants and appropriations as a source of funding of projects in community hospitals decreased from 11.2 percent to 3.5 percent, and philanthropy from 9.9 percent to 4.2 percent. Moreover, certain provisions of the Economic Recovery Tax Act of 1981 are expected to contribute to a further decline in philanthropic gifts as reductions in the personal tax bracket from 70 percent to 50 percent reduce the incentive for philanthropic contributions. Over the same period, reliance on debt increased from 67.3 percent to 75.8 percent as an overall source of project funding. Seventy-eight percent of that debt was in the form of tax-exempt bonds in 1981.

### *Volume*

In 1981, hospitals used $5.04 billion in tax-exempt bonds, representing 10.9 percent of the tax-exempt market. The Bond Buyer reports $9.7 billion in hospital tax-exempt bonds for 1982, or 12.3 percent of the tax-exempt market. According to AHA figures, 10 states account for over 60 percent of all reported tax-exempt debt. They are, in order: Pennsylvania, Ohio, New Jersey, Florida, Texas, California, Illinois, Massachusetts, Kentucky, and New York.

It should be noted that while the volume of tax-exempt bonds has increased from $262 million in 1971, to $2.7 billion in 1976, to over $5 billion in 1981, in constant (1967) dollars, the growth has been much more moderate—from $216 million in 1971, to $1.6 billion in 1976, to $1.8 billion in 1981.

### *Uses of capital*

The vast majority of hospital capital projects are undertaken to replace or renovate facilities and equipment. These are legitimate and necessary projects that require capital but add no new beds to the existing health care delivery system. Over the past five years, community hospitals have increased their number of beds on average of only 1.1 percent each year.

It is not true, as some contend, that the growing use of tax-exempt financing by hospitals has contributed to a growth in construction. During the period 1975 through 1981, when the proportion of hospital construction financed with tax-exempt bonds rose from 31 percent to 54 percent, hospital construction spending was relatively stable, rising from $3.06 billion in 1975 to $4.3 billion in 1981. When inflation during that period is discounted, the real value of hospital construction actually dropped to $2.2 billion in 1981.

According to AHA's Construction Survey for 1981, nearly 75 percent of hospital projects undertaken were for modernization. Moreover, approximately 35 percent of all tax-exempt financing can be attributed to financing costs and restructuring outstanding debt.

### *Checks on capital expenditures*

Existing federal health planning authority and many state regulatory agencies continue to monitor the need for major capital expenditures by hospitals. Certificate of need (CON) review procedures are also required to verify the need for capital expenditures, major medical equipment purchases, and new institutional health services proposed by hospitals. CON approval of projects is also taken into consideration by bankers and state bonding authorities in making decisions to approve or deny tax-exempt financing for hospital projects.

In addition, the recent enactment of prospective payment legislation, which changes Medicare payments to hospitals from cost-based reimbursement to pricing based on diagnosis-related groups (DRGs), will change hospital incentives. The shift in Medicare to fixed prices will force hospitals to be even more cautious in capital spending, because subsequent operating revenues are not guaranteed to support the capital asset.

## REASONS FOR INCREASED USE OF TAX-EXEMPT BONDS BY HOSPITALS

While hospitals continue to make record use of the tax-exempt market, there is no evidence that they are abusing this source of capital. Four factors can be cited as largely influencing the recent heavy use of the tax-exempt market. These include declining interest rates, the need for refinancings, increased costs resulting from bond registration, and large capital needs.

### *Interest rates*

The drop in interest rates in the second half of 1982 brought into the market many hospitals which had been delaying needed projects. In January 1982, a typical hospital bond issue yielded approximately 15 percent, while in September 1982, yields were less than 10 percent. By year's end, hospital debt yielded about 11 percent, and last month (May 1983) hospital tax-exempt debt was yielding between 9.5 percent and 10 percent.

### *Refinancing*

Because of declining interest rates, some hospitals which had entered the market earlier chose to refinance (re-fund) their outstanding debt at more favorable rates. In 1982, re-funding alone is estimated to have accounted for between 3 percent and 5 percent of total hospital tax-exempt issues. However, according to the Public Securities Association, re-funding activities in 1983 represent almost 15 percent of overall market volume and 26 percent of the hospital volume. Significantly, refinancing at lower rates reduces Medicare costs, because interest payments are reduced.

### *Bond registration*

The Tax Equity and Fiscal Responsibility Act of 1982 included a provision requiring the registration of all tax-exempt bonds issued after January 1, 1983. In an effort to avoid the extra costs of issuing bonds in registered form, many issuers rushed to the market in late 1982. The deadline for registration was later postponed until July 1983, so, again this year, bond market activity is artificially heavy.

### *Large capital needs*

Estimates of hospital industry capital needs for the 1980s generally exceed $150 billion. One firm estimates a $54 billion shortfall by the end of the decade. These substantial capital requirements and shortfalls suggest that capital may well be the most critical issue facing the hospital industry today.

These capital needs reflect the fact that much of the current hospital capacity was built during the 1950s and 1960s and is entering the stage at which major renovation and/or replacement is needed. Furthermore, the growth of the elderly population, with its high utilization rate, and demographic shifts to the sun belt have resulted in the need for new hospital construction in some areas of the country.

There have been many estimates by different sources of future capital requirements of hospitals. They include:

ICF, Inc.: $163 billion between 1980 and 1990; [1]
Kidder, Peabody & C.: $193 billion between 1980 and 1990; [2]
Lightle and Plomann: between $100 and $145 billion over 20 to 25 years beginning in 1979; [3]
Reed and Winston: over $100 billion between 1981 and 1990; and [4]
Cohodes and Kinkard: between $80 and $100 billion in the 1980s.[5]

## IMPORTANCE OF TAX-EXEMPT BONDS TO NONPROFIT HOSPITALS

### *Medicare/Medicaid impact*

Since the federal government pays for about 40 percent of all hospital care, it obviously has an interest in the cost of capital used to finance that care. If hospitals are forced to enter the taxable bond market fo finance capital projects through commercial lending sources, the additional costs of hospital care will be significant and ultimately will be absorbed by Medicare, Medicaid, and other payers. During 1980, the savings to Medicare and Medicaid due to tax-exempt financing was estimated to be at least $150 million.

### *Reduced costs*

At a time when health care providers, consumers, Congress, and the federal government are most sensitive to restraining the increase in health care costs, tax-exempt financing is an important contributor to minimizing the costs of capital projects. In the recent past, the interest rate for tax-exempt bonds was about 3 percentage points lower than comparable taxable obligations.

### *Impact on financially weak hospitals*

While some nonprofit hospitals that are fiancially healthy may be able to use other debt financing options, financially weak hospitals will generally be unable to use those alternatives and might be denied access to capital if tax-exempt financing were not available. These hospitals are characterized as those providing substantial amounts of charity care of serving high proportions of Medicare and Medicaid beneficiaries. These types of hospitals are typically small and located in rural, isolated areas or are large hospitals located in inner cities. As a matter of public policy, Congress should not penalize those hospitals which are most committed to serving the aged and poor.

### *Public purpose*

Most importantly, we strongly believe that private nonprofit hospitals serve an unquestionable public purpose in providing high quality health care services to communities. The vast majority of hospitals in this country provide essential and highly complex services, often at no charge to the poor and medically indigent. A study conducted jointly by AHA and the Urban Institute—a survedy of 453 hospitals of which 86.7 percent were private nonprofit facilities—indicates that large private hospitals averaged about $9.5 million in free care to the poor, while small private hospitals provided an average of $3.4 million.

In addition, hospitals also serve society through their education and research activities. Clearly, the continuing viability of our nation's nonprofit hospitals depends upon their success at capital formation.

## CONCLUSION

In summary, the need for capital over the next decade is one of the most crucial issues facing the hospital industry. With the declining role of philanthropy and government grants in financing hospitals capital needs, and the limited opportunities to generate capital through patient operations, tax-exempt financing has become the most cost-effective method of capital financing. Moreover, as institutions serving a public purpose that are vital to their communities, tax-exempt financing is an appropriate form of assistance.

---

[1] Valiante, J. The need for capital in health care: the national picture. Presentation, N.Y. State Assembly Forum on Capital Financing for Health Care, Apr. 29, 1982. Also, the dimensions of capital requirements. Presentation, National Health Lawyer's Association, Jan. 20, 1982.

[2] Henkel, A. and Hernandez, M. Capital financing issues. Presentation, Society for Hospital Planning Seminar on Strategies for Hospital Diversification, Mar. 30–31, 1982.

[3] Lightle, M.A. and Plomann, M.P. Hospital capital financing entering phase four. "Hospitals." 55:61, Aug. 1, 1981.

[4] Reed, T. and Winston, D. Difficult transition ahead: capital formation under the Reagan administration. *"Hospital Financial Management."* 11:6, June 1981.

[5] Cohodes, D. and Kinkead, B. *"Hospital Capital Formation in the 1980's: Is There a Crisis"*? Study prepared at The Center for Hospital Finance and Management, The Johns Hopkins Medical Institutions; funded by The Robert Wood Johnson Foundation; Aug. 1, 1982.

Hospitals continue to make increased use of the tax-exempt market because of four factors: declining interest rates, refinancings, increased costs resulting from bond registration, and large capital needs.

If nonprofit hospitals are forced to turn to the taxable market, the overall cost of health care would rise. Moreover, the federal government would share in these increased costs through the Medicare and Medicaid programs, as would private payers and patients through increased premiums and charges.

## STATEMENT OF RON LINTON, EXECUTIVE DIRECTOR, COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES, WASHINGTON, D.C.

Mr. LINTON. Mr. Chairman, for the record let me state that my name is Ron Linton, and I am the executive director of the Council of Pollution Control Financing Agencies. I apologize for Ronald Bean's—our president—inability to be present today, but the Illinois Legislature is in its last 3 days of session, and no prudent State official would leave the State as the legislature enters its last 3 days of the session. He has asked me to appear for him.

I would ask that his statement be inserted in the record. And also, in the statement is reference to a study that was commissioned by the Council of Pollution Control Financing Agencies which has previously been given to the committee, and I would hope that will appear in the record as well.

Let me just make a few points about the position of the Council of Pollution Control Financing Agencies on the use of pollution control financing, by recalling that pollution control financing was a specific response to supplement a national policy. The Congress has mandated over the years a cleanup of air, water, solid, and hazardous waste problems in the United States, and one of the mechanisms to assist in doing this was to provide a tax-exempt means of aggregating capital in order to install the facilities necessary to meet those requirements.

Pollution control facilities by themselves add nothing to the productive capability of any firm. They have no value in themselves. They do not add to either the profits or to the assets of the business operation. It would seem only reasonable and fair to allow for the aggregation of capital to achieve public policy in the least expensive way possible.

Furthermore, it seems to us counterproductive to drive industry to compete in the taxable money markets for nonproductive equipment at a time when we are enhancing the aggregation of capital to expand our economy.

Critics of pollution control financing maintain that it deprives the Treasury of significant revenues. We have been unable to obtain any kind of data or background from those critics to be able to analyze how they arrived at the figures they did, and so we asked Data Resources, Inc., and Coopers & Lybrand to make a study to determine just what is the potential loss in revenues to the Treasury.

Now, the two groups themselves couldn't agree on what the loss was, but in their disagreement they were still substantially lower as to what the revenue losses would be to the Federal Treasury if pollution control financing was eliminated—ranging in 1983 as a $70 million loss, up in 1985 to a $250 million loss.

But *one of their conclusions was most interesting, and that was* that the bulk of those who acquire pollution control financing are individuals and investors seeking tax shelters, and the assumption is that if the pollution control financing is not available they will simply seek other tax shelters. If we are going to eliminate the revenue loss to the Treasury, then we would have to eliminate all tax shelters so there is nowhere for the money to go. This is just like water seeking its own level.

Contrary to curtailing the use of pollution control financing, I would suggest to the Committee that it would be even more important to expand it, so that it would be applied to the facilities for hazardous waste disposal—something of a great problem in this country today—and that it also be expanded to apply to preventing pollution activities rather than simply to the cleanup of pollution activity. I think it is a valuable tool used to meet the public policy requirements that Congress has imposed.

I appreciate very much the opportunity to appear before the committee today.

[The prepared statement of Ronald Bean follows:]

## STATEMENT ON BEHALF OF THE COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES BY RONALD BEAN

Mr. Chairman, members of the Committee, I am Ronald Bean, Executive Director of the Illinois Environmental Facilities Financing Authority. I appear before this Committee as President of the Council of Pollution Control Financing Agencies. On behalf of the Council, I welcome the opportunity to provide the Committee with our views regarding proposals to modify the availability and use of tax-exempt financing for pollution control facilities.

Mr. Chairman, proposals to restrict the use and availability of IDBs for pollution control financing fail to recognize the critical and distinct purpose of PCIDBs. Currently, efforts are being made to deny ACRS benefits in conjunction with the use of a PCIDB. ACRS benefits are specifically for the company that is modernizing to assure its capital investments do not act as an economic drag on the company. PCIDBs provide the means for a company to ease the costs associated with the nonproductive nature of pollution control expenditures and enhance its economic viability. Pollution control costs do not add to a company's assets.

Pollution control expenditures are a non-productive expenditure in the sense that pollution control facilities do not increase a firm's productivity. However, these expenditures are mandated to serve a public purpose, provide a cleaner environment. It is critical to note these investments are required by law. No distortion in resource allocation occurs, except an effort to meet a desired and mandated public goal, clean air, water and land.

The U.S. Department of the Treasury and PCIDB critics have argued that these bonds deprive the Federal Treasury of much needed revenues, because of their tax-exempt nature. A study the Council of Pollution Control Financing Agencies commissioned stated that additional tax revenues would not be gained from further PCIDB restrictions. The study stated investors who would ordinarily purchase PCIDBs will seek other tax shelters to invest resources. Thus, the study concluded, in order to increase the Treasury's revenues, it would be necessary to eliminate all existing tax shelters. In addition, businesses who depend on PCIDBs would be forced to rely on taxable capital. This circumstance would increase a business' interest tax deduction and subsequently deny the Treasury's additional revenues. In fact, PCIDBs are such a small portion of the capital market, that Data Resources, Inc. concluded in its analysis that elimination of pollution control bonds would only provide a revenue gain of $70 million in 1983, rising to $250 million in 1985. The study's two authors could not even arrive at a definitive revenue loss to the Treasury attributable to PCIDB use.

The study found PCIDBs are a small part of the capital market that fail to impact the cost of other borrowings. As a portion of all Federal, State and local government debt, PCIDBs account for only 1.5 percent of this debt. There is no reason to restrict PCIDBs.

Last year Congress enacted the Tax Equity and Fiscal Responsibility Act *(TEFRA). TEFRA contained many provisions regulating IDB use. Many of these* provisions are yet to be implemented. Therefore, we urge this Committee not to enact further restrictions until such a time when the TEFRA provisions can be analyzed as to their effect on the IDB market.

The Data Resources Inc./Coopers and Lybrand analysis leads to a conclusion that new restrictions are unwarranted. Congress should, however, amend the current use of PCIDBs in another manner. Congress should provide for the financing of abatement and process oriented technologies to promote the use of the cost efficient pollution control technology that is available. Currently, the tax code provides an incentive to create pollution rather than prevent pollution creation through abatement and process technologies because only control technologies are eligible for PCIDB financings. By providing for PCIDB financing of abatement and process oriented technologies, mandated, non-productive control costs can be lessened.

Second, the Council urges the Committee to provide PCIDB financing for hazardous waste facilities. Currently, the Treasury Department defines solid waste as nonhazardous wastes, citing the definition contained in the Solid Waste Disposal Act. However, Congress, in the Resource Conservation and Recovery Act, expanded the solid waste definition to include hazardous wastes. Congress should direct the Treasury to amend its definition of solid waste to include hazardous waste management facilities as eligible for PCIDB financings. For the record, I am attaching material supporting the expansion of current authority to include the financing of hazardous waste facilities.

The Data Resources, Inc./Coopers and Lybrand study and the issues surrounding the use and availability of pollution control financing indicate that further restrictions are unwise and would not lead to the desired end that proponents of new restrictions envision. Instead, it would lead to exactly opposite results.

PCIDB use has been much overstated. PCIDBs represent a small percentage of the total tax-exempt bonds sold. In addition, they are even a smaller percentage of the tax-exempt bonds outstanding. The partial subsidy provided through the tax code to businesses installing pollution control technologies should be viewed as a contribution to, rather than a perversion of, meeting the desired end of a public policy decision, preservation and enhancement of the environmental quality of life.

Should further IDB restrictions be enacted, the consequences would be the need for an additional bureaucracy to regulate the use of PCIDBs, and IDBs in general. In tandem with proposals such as H.R. 1635, revenue losses to the Treasury would be exacerbated as investors in PCIDBs would turn to other tax shelters and businesses to gain higher interest tax deductions.

For these reasons, the Council concludes that further IDB restrictions are unwise and will only lead to a decrease of the nation's progress to enhance the environmental quality of life.

Mr. Chairman, this concludes my formal testimony. I would be happy to respond to any questions the Committee may have.

### SUPPORTIVE DATA

1. Sections 103(b)(4) (E) and (F) of the Internal Revenue Code provide the only meaningful tax incentive in the Code for the acquisition of solid waste disposal or air or water pollution control facilities. Unfortunately the availability of tax exempt financing is restricted under proposed Treasury regulations which, notwithstanding EPA's objections, define pollution control facilities as only those devices that operate at the end of the production process. The rule is that any system that eliminates the creation of pollution is not for air or water pollution control. This "realized pollution" test disregards the fact that state or local governmental units and corporate citizens are designing nonproductive pollution control facilities pursuant to EPA mandate and modern technology. Further the regulations are contrary to the standards required for treating hazardous waste under RCRA.

2. The Council of Pollution Control Financing Agencies, as well as EPA, has concluded that the service's interpretations are counter productive to the nation's environmental and energy policies. Since Treasury and the Service have ignored all requests for change, Congress must enact technical amendments to section 103(b) that will insure tax exempt financing for companies and local government units which acquire pollution control and/or solid waste disposal facilities.

3. Since 1970, governmental units and corporations, in an effort to support the nation's environmental and energy goals have spent billions of dollars for air and

water pollution control and the treatment of solid wastes. These expenses will continue into the 1980's, particularly because of the treatment of hazardous wastes required under RCRA.

4. Since the Treasury regulations do not recognize the treatment of hazardous waste as being for the control of air or water pollution or solid waste, such expenditures are denied, arbitrarily, the benefits of tax exempt financing. Further, since all potential polluters are adoption technology for eliminating pollution rather than designing facilities that operate on pollutants at the end of a pipe, they are precluded from fully utilizing Section 103(b)(4)(F). This denial is unfair—the tax incentive already exists—and adds to the costly burden of acquiring nonproductive assets.

5. The proposed regulations penalize governmental units and corporations for being good citizens.

6. Congress should enact technical amendments to Sections 103(b)(4) (E) and (F) to guarantee that those who comply with the nation's environmental and energy standards will obtain the existing statutory tax incentives.

## INTRODUCTION

The Council of Pollution Control Financing Agencies is a Section 501(c)(3) organization devoted toward the education of the public through an annual symposium, workshop programs and publications of the nation's environmental standards including analyses of regulatory actions. Its voting members are state or local government agencies charged with aiding either state or local government units or companies in financing their environmental compliance programs. Attached hereto as Exhibit A is a more complete description of the Council.

Its non-voting members consist of public members such as investment bankers, law firms and companies. This broad based membership has allowed the Council to establish a liaison with officials with policy responsibilities affecting pollution control financing at the Environmental Protection Agency, Council on Environmental Quality, Treasury Department, Securities and Exchange Commission, and Small Business Administration.

The combination of Council policy and membership affords the Council a unique position within our system. It is from this broad base of experience that the Council has learned of a serious problem relating to pollution control financing caused by the Internal Revenue Service and proposed Treasury Regulations. Further, the Council believes the harmful effects of the regulations will be exacerbated by reason of the need for compliance under RCRA. Accordingly, the Council appears before this Committee to suggest that it act immediately to clarify Sections 103(b)(4) (E) and (F) as discussed below. Since the Service and Treasury have ignored both EPA and the Council's comments that the regulaitons are contrary to Congressional intent, inconsistent with national environmental and energy policies and detrimental to both state and local governmental agencies charged with financing environmental protection systems and companies efforts to finance nonproductive facilities, Congress must intervene.

## PRESENT LAW

Industrial development bonds, *i.e.*, bonds defined in Section 103(b) of the Code as being issued by or on behalf of states or their political subdivisions for the benefit of private businesses, generally do not bear tax exempt interest under Section 103(a). However, where the proceeds of the bonds will be used for certain "exempt activities" (*e.g.*, air or water pollution control facilities, solid waste disposal facilities, etc.) the bonds will bear tax exempt interest.

## REALIZED POLLUTION TEST

The Treasury and the Internal Revenue Service have promulgated and proposed various definitions of the types of facilities that may be regarded as being pollution control and solid waste disposal facilities. Many of these rules so narrowly restrict the types of facilities qualifying for tax exempt bond financing that they are contrary to the underlying statute and to some of the policies of the EPA.

In particular, Proposed Reg. §§ 1.103-8(g)(2)(ii), (iii) and (iv) adopt a "realized pollution" test. This test holds that facilities which prevent pollution are not for the control of pollution. Thus only "end of pipe devices" qualify for tax exempt financing. Excluded by the regulatory definition of air or water pollution control are such facilities, even if acquired pursuant to EPA mandate under the Clean Air Act, the Federal Water Pollution Control Act, or RCRA, that treat hazardous waste, eliminate the creation of a pollutant through process changes, control a "nuisance", or are used "traditionally or customarily" by an industry. This interpretation belies Congressional intent and is at odds with the modern methods of pollution control which are being developed by industry in cooperation with the EPA.

The law permitting tax exempt financing of pollution control and solid waste disposal facilities was enacted in 1968 to encourage the installation of such facilities. Such equipment is frequently placed in service because public policy demands that the environment be protected even though this may require investment that either is unprofitable for a producer or involves a high degree of financial risk. The Service's failure to give proper recognition to these facts is philosophically unfair and statutorily improper.

### GROSS SAVINGS TEST

Assuming the facility meets the so-called "realized pollution test", the position of the Internal Revenue Service is that the allowable amount of financing for a pollution control facility is its cost reduced by the value of any recovered useful by-product, or the value of any form of "gross" economic benefit to the manufacturer.

Proposed Reg. § 1.103-8(g)(3) guarantees a reduction in allowable financing even where off-setting costs of operation associated with a pollution control device equal or exceed the alleged benefits. This formula is inconsistent with EPA guidelines, contrary to standard accounting methods, and legally arbitrary.

### HAZARDOUS WASTE

As stated earlier, facilities which treat hazardous wastes fail to meet the realized pollution test and accordingly do not qualify as an air or waste pollution control facility under Section 103(b)(4)(F). Even if such devices are acquired pursuant to the Solid Waste Disposal Act, the Treasury regulations deny tax exempt financing under Section 103(b)(4)(E).

In the case of the exemption for solid waste disposal facilities, the term "solid waste" has been defined by the Internal Revenue Service to mean solid waste within the meaning of the Solid Waste Disposal Act as it existed in 1968, despite the fact that the Act has been amended to modernize the government's response to the problem of solid waste disposal. Thus, for example, solid waste disposal facilities as defined and mandated by Congress in RCRA are excluded from qualifying for tax-exempt financing.

### CONGRESS MUST ACT—PROPOSED BILL OR AMENDMENT

The Committee should pass a bill or an amendment, the purpose of which would be to clarify the meaning of the terms "solid waste" and "pollution control" for purposes of Sections 103(b)(4) (E) and (F). It should be clear that the Committee believes that the Treasury and Internal Revenue Service's interpretations are too restrictive and that a reasonable definition of those terms was intended by the Congress when it originally enacted Section 103(b)(4). Further, the Committee should make it clear that artificially narrow definitions do not promote the legislative purpose of the provision, i.e., to encourage pollution control and solid waste disposal.

The definition of pollution control facilities should include any facility that is installed, in whole or in part, for the purpose of abating, controlling, or preventing water or atmospheric pollution so long as a certification to that effect is given by a responsible local, state or federal environmental agency. The effect of such a provision would be to ensure that environmental agencies have the authority to determine whether or not tax incentives are consistent with overall environmental policy. Thus, statutorily, the prevention of pollution is the same as the control of pollution.

In order to guarantee that only the portion of the cost of pollution control facilities which are not recouped by net economic benefits is eligible for financing, the bill could provide for a reduction in costs eligible for financing to the extent of net economic benefits. No such reduction should be made, however, where the facility is installed primarily for pollution control. Thus, the bill should provide a conclusive presumption that the entire cost of a facility qualifies for tax-exempt financing if the facility would not have been installed but for pollution control purposes.

In the case of solid waste disposal facilities, the bill should contain the provisions of present law which recognize and encourage economic solid waste disposal, including resource recovery and profit-making recycling. However, the bill clarifying the definition of solid waste can be accomplished so that it is the same definition of "solid waste" that is contained in The Solid Waste Disposal Act as amended. This provision will negate the unrealistic idea that the definition of solid waste under

Section 103 of the Code is to remain frozen to 1968. Solid waste disposal facilities under Section 103 reflect changing environmental policy. Thus, for example, the bill should include hazardous waste within the definition of solid waste.

### CONCLUSION

The Council of Pollution Control Financing Agencies, as well as many taxpayers, and the EPA have advised the Treasury and Internal Revenue Service that its regulations are legally arbitrary and inconsistent with the Nation's environmental and energy goals. Since these comments have not been repudiated i.e., they have been totally ignored, Congress must amend Sections 103(b)(4) (E) and (F) to guarantee that environmental judgments can be made by those entities capable of ascertaining most intelligent environmental policy without prejudicing governmental units of companies tax rights.

---

## AN ANALYSIS OF TAX-EXEMPT POLLUTION CONTROL FINANCING, PREPARED FOR THE COUNCIL OF POLLUTION CONTROL FINANCING AGENCIES

### INTRODUCTION

This report discusses the development and use of pollution control industrial development bonds (PCIDBs) and their effects on the U.S. economy relative to other forms of long-term debt. The second section provides a description of pollution control financing as a specialized form of industrial development bond used to finance construction of pollution control facilities required under federal environmental regulations. The third section describes the impact of PCIDBs as tax-exempt investments.

The lack of adequate publicly available information on individual PCIDB issues has required use of some simplifying assumptions in this report. These are listed below.

Since there has been no requirement that PCIDBs be registered with the federal government or with many state governments, the volume of PCIDBs used in our analysis consists of those reported to organizations such as the Public Securities Association, The Bond Buyer and Moody's Bond Report. This significantly understates the total volume of PCIDBs, as many fall in the category of small issues and are privately placed in local banks. Other issues have been reported to one of the organizations listed above, but not to the others. Thus, reports of PCIDB sales vary, even among the organizations that compile this information regularly. Accurate figures for the sales of small issue IDBs are not available, and the best estimates, prepared by the Congressional Budget Office in 1982, do not distinguish between small issue PCIDBs and others. Estimates of the value of small issue IDBs have been given for a few individual years, but there is not consistency in these estimates, so only reported PCIDB issues have been used. Information published in the Daily Bond Buyer has been the major source of PCIDB data.

There is no compiled information showing PCIDB volume outstanding. Therefore, data shown in this report are generally for new issues of IDBs. Since the first PCIDBs were issued in 1971, and because until the past few years most PCIDBs were long-term issues, the number of PCIDBs maturing since 1971 is assumed to be no higher than 5 percent. Therefore, where a value is given for PCIDBs outstanding, it has been calculating using this assumption.

It was assumed that purchasers of PCIDBs are similar in composition to the purchasers of municipal bonds, and that the majority of PCIDBs are currently purchased by households or Municipal Bond Funds, the fastest growing segments of the population of municipal bond holders. No statistics were available regarding, specifically, the purchasers of PCIDBs.

### INDUSTRIAL DEVELOPMENT BONDS: A BRIEF OVERVIEW

Tax-exempt securities have been the traditional mechanism of state and local governments to finance public improvements such as schools and roads. In recent years, another category of tax-exempt securities, generally referred to as industrial development bonds (IDBs) has become important. IDBs are tax-exempt bonds whose proceeds are used by individuals and organizations which are not tax-exempt and the obligation is secured by the property and receipts of the project rather than the full faith and credit of the issuer. The first condition requires that the proceeds are used by a taxable entity and is called the "trade or business test," while the second condition requires that the obligation is secured by the project's receipts and is called the "security interest test." The bonds are sold by states, state agencies, counties and cities, and the proceeds of the bond sales are generally either loaned to private firms, or used to acquire facilities which are then leased to private firms. Although some IDBs have been general obligation bonds backed by the issuers' taxing power, virtually all IDBs are now revenue bonds, secured by the property or receipts of the project financed. IDBs are thus priced by the market primarily on the basis of the credit worthiness of the private participant rather than the public user. Thus, the governmental unit serves as a financial intermediary, offering the firm lower borrowing costs because of the tax-exempt features of IDBs.

The use of tax-exempt credit for private purposes originated in 1936 in Mississippi. Such issues remained small and localized in the South through the 1950s. In the early 1960s, IDB issuance rose substantially. More issuers adopted the revenue version of IDBs. The enactment of the Revenue and Expenditure Control Act of 1968 denied tax-exempt status to IDBs except those designated as "small issues" or those that finance certain types of facilities. The small issue exemption limits the issue to less than $10 million. Certain facilities are exempt from the small issue restrictions. These facilities are low income residential property; sports facilities; convention facilities; transportation facilities; sewerage, water, solid waste and energy facilities; qualified mass transit vehicles; and air and water pollution control facilities.

The use of IDBs accelerated in the 1970s when large numbers of smaller issues were sold. By 1979, IDBs reached $9.8 billion or 32.9 percent of total tax-exempt obligations. This continuing growth of tax-exempt financing for private purposes led Congress to curb financing of housing by IDBs. Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) place several additional restrictions on IDBs. These restrictions include sunsetting of the small issue exemption after 1986, a limitation of straight-line depreciation over ACRS asset lifetimes (not applicable to pollution control facilities installed in existing plants), and established reporting requirements which will go into effect July 1, 1983.

Pollution Control IDBs (PCIDBs) are revenue bonds secured by corporate payments on leases, installment sales, loans, or guarantees as are most IDBs. Pollution control exemption regulations are complex and place heavy emphasis on the relationship of the pollution control improvement to the overall industrial process. Users must show that the improvement to be financed by PCIDBs is for the control of pollution and is not designed to meet any significant purpose but pollution control. The PCIDBs receive ratings based primarily upon the type of security feature and the credit worthiness of the user of the pollution control facilities.

PCIDBs were first issued in 1971. In that year, $0.1 billion were sold through 10 issues. PCIDB sales have increased since to a high of $6.1 billion sold through more than 150 issues in 1982. The PCIDB offers several advantages to the borrower. The first is reduced interest costs due to the tax-exempt feature of the bond. Generally, tax-exempt securities earn yields that are roughly 70 percent of those of comparable taxable securities. This implied a differential of nearly 400 basis points in 1981, which translates into a gross savings of roughly $8 million in interest costs on a $10 million issue with a 20-year maturity. Second, SEC registration costs and related legal expenses may be avoided, since the bonds need not be registered. However, PCIDBs involve additional costs not found in taxable financing such as municipal bond counsels' fees, other municipal fees, and higher underwriters' fees than usually found in the tax-exempt market. Third, in some cases, the borrower may be exempt from various state and local taxes. Fourth, through leasing arrangements that can become rather complex, the borrower can achieve additional savings, through accelerated depreciation, and investment tax credits, or by leasing through third parties.

The impact of PCIDBs on various segments of the economy is described in the following section.

## THE ECONOMIC IMPACT OF PCIDBS

The volume of PCIDBs is quite small relative to other debt instruments in the economy. However, the account for a substantial amount of the financing for the pollution control facilities that are required under federal environmental regulations. Although their impact on the overall economy is slight, they are an important source of financing for industries that are required to make a large investment in pollution control facilities. This report identifies the issuers and purchasers of PCIDBs, and analyzes the impact of PCIDBs on the capital markets and on the Treasury.

The data used in this analysis were compiled from published information in the Daily Bond Buyer and other trade publications as well as reports prepared by the

U.S. Treasury Office of Tax Analysis, the Congressional Budget Office and the Federal Reserve.

*Issuers and Purchasers of PCIDBs*

*Industry use of PCIDBs.*—The major impetus for PCIDBs was the passage of Federal environmental legislation, namely the National Environmental Protection Act of 1969, the Clean Air Act of 1970, and the Water Pollution Control Act of 1972. Other legislation, particularly the Power Plant and Industrial Fuel Use Act of 1978, the Resource Conservation and Recovery Act, the Safe Drinking Water Act and the Superfund legislation have also provided important incentives to the growth in PCIDB sales. These laws require large-scale investment by industry to meet the legislated environmental standards. As shown in Table 1, pollution control plant and equipment expenditures (PABE) rose from $3.9 billion in 1972 to $9.2 billion in 1980 before declining to $8.9 billion in 1981. The percent of PABE financed by PCIDBs has averaged about 32 percent, ranging from 15 percent in 1972 to 44 percent in 1981. The future growth of PCIDBs depends on the volume of PABE needed to satisfy pollution control standards and the ability of state and local governmental units to sponsor tax-exempt financing which depends on individual IRS rulings and changes in tax and environmental legislation.

TABLE 1.—PCIDB'S AS A PERCENT OF POLLUTION CONTROL PLANT AND EQUIPMENT EXPENDITURES

[Dollars in billions]

| | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|---|---|---|
| Pollution control plant and equipment [1] | $3.9 | $4.9 | $5.7 | $7.0 | $7.2 | $7.3 | $7.6 | $8.4 | $9.2 | $8.9 |
| PCIDB's [2] | .57 | 1.8 | 1.7 | 2.1 | 2.1 | 3.0 | 2.8 | 2.5 | 2.5 | 3.9 |
| Percent | 15 | 37 | 30 | 30 | 29 | 41 | 37 | 30 | 27 | 44 |

[1] U.S. Department of Commerce, Bureau of Economic Analysis.

[2] The Daily Bond Buyer.

Of particular importance is a TEFRA provision that restricts the use of ACRS depreciation for air and water pollution control facilities financed by tax-exempt bonds to those built for use in connection with plants or other property in operation, under construction or financed before July 1, 1982. This limitation, in effect, will force industry to choose between tax-exempt financing for pollution control equipment on new plants using a straight-line depreciation write-off, or using taxable financing and a faster write-off of depreciation. No longer will both tax-saving provisions be available for new construction.

The major users of PCIDBs have been electric utilities and oil and chemical companies. Other significant users are paper companies, manufacturers and metal processors. Electric utilities have consistently been the chief industrial beneficiaries of PCIDB financing, accounting for more than 65 percent of PCIDB sales in 1977 and more than 70 percent in 1981. Much of this financing was required in the wake of the 1970's energy crisis as existing power plants switched from oil and gas boilers to coal-fired generators, which require extensive pollution control installations, and new power plants were built to use coal. The dollar value of PCIDBs issued for electric utilities ranged from $60 million in 1973 to $2.2 billion in 1977 and $2.75 billion in 1981. Preliminary reports based on the first three quarters of 1982 indicate that the utilities' proportion of PCIDBs sold was still the highest of any industry, with an annual dollar value more than $3 billion. The value of PCIDBs used for utilities' conversion to coal can be expected to decline as most of the conversions prompted by the 1970's energy crisis are completed.

The other major users of PCIDBs listed in Table 2 are expanding their pollution abatement expenditures for both air and water pollution control, and most facilities so financed are being constructed to meet extended compliance deadlines of the Clean Air Act and the Water Pollution Control Act. Under the Water Pollution Control Act, industrial point sources of pollution were required to adopt "the best practicable control technology currently available" by 1977 and the "best available control technology achievable" by 1984 in order to meet federal effluent standards. Provisions of the Clean Air Act specify design criteria for certain industries and require industry to operate within certain stationary source air pollution standards. In addition, under the Clean Air Act, construction of new facilities emitting high levels of pollutants has been restricted until national ambient air standards are met.

### TABLE 2.—DISTRIBUTION OF PCIDS USERS BY INDUSTRY

[Percent]

| | Years | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
| Percent of PCIDB's By Industry: | | | | | | | | | |
| Electric utilities | 33 | 56.3 | 29.3 | | 65.3 | | | 58.0 | 70.2 |
| Metal processing | 22 | 10.7 | 24.7 | | | | | | |
| Oil companies | 5 | 11.7 | 10.3 | | | | | 4.8 | 11.2 |
| Manufacturing | | | | | | | | | 5.2 |
| Chemical | 11 | 4.7 | 11.8 | | | | | | 4.5 |
| Forest products (paper) | 11 | 9 | 10.4 | | | | | | 3.0 |
| Total given percent | 82 | 92.4 | 86.5 | | 65.3 | | | 62.8 | 94.1 |

Source: The Bond Buyer.

The effects of the elimination of PCIDBs would vary significantly by industry. With PCIDBs, certain firms and certain investments receive lower interest costs from tax-exempt financing. Their borrowing costs are lower per dollar by the difference between the taxable and tax-exempt financing rate.

*PCIDB purchasers.*—The purchaser of PCIDBs is assumed to have similar investment needs and strategies as the purchaser of other municipal bonds. As shown in Table 3, commercial banks, households, property liability companies and municipal bond funds are the largest participants in the municipal bond market. Households and municipal bond funds have been the fastest growing segments since 1975. It can be assumed that the composition of PCIDB holders is similar to that of the municipal bond market in general.

### TABLE 3.—HOLDERS OF MUNICIPAL BONDS

| Holder | (Dollars in billions) outstanding Dec. 31, 1982 | Cumulative change (1975–1982) | Projected net change 1983 |
|---|---|---|---|
| Domestic commercial banks | 157.0 | +55.1 | +5.8 |
| Households | 138.5 | +67.4 | +35.0 |
| Property liability companies | 86.4 | +53.1 | +2.4 |
| Municipal bond funds | 48.7 | +42.6 | +15.8 |
| Life insurance companies | 8.2 | +2.9 | +.9 |
| State and local retirement funds | 4.0 | +2.1 | −.1 |
| Nonfinancial business corporations | 3.6 | −1.0 | −2.5 |
| Mutual savings banks | 2.2 | +.7 | 0 |
| Secretary brokers and dealers | 1.4 | +.9 | +.7 |
| Savings and loans | 1.1 | −.4 | −.1 |
| Total | 451.1 | +223.4 | +57.9 |

Source: Salomon Brothers, 1983 Prospects for Financial Markets.

It is likely that most purchasers of PCIDBs are individuals, either buying for their own account or through investments in municipal bond funds. As long as interest rates remain high relative to the return on other investments, all bonds will be attractive investments. The higher an individual's tax bracket, the more attractive tax-exempts will be. As the yield on tax-exempts increases relative to the taxable rate, the attractiveness of all tax-exempts increases for individuals with marginal tax rates equal to one minus the ratio of the tax-exempt rate to the taxable rate. Thus, as the tax-exempt rate has generally been about 70 percent of the taxable rate, tax-exempt bonds are most attractive to individuals with marginal tax rates higher than 30 percent. Individuals in the 30 percent tax bracket are indifferent between tax-exempts and taxables, as their return would be the same from either investment. Individuals with marginal tax rates of less than 30 percent would prefer taxable investments, as long as the tax-exempt rate remains no higher than 70 percent of the taxable rate. As the supply of tax-exempts increases relative to taxables, however, the relative tax-exempt rate rises to attract investors in the lower brackets.

*PCIDB impact on capital markets and the Treasury*

*Economic and Market Forces.*—The criticism of IDBs is based on the economic argument that IDBs provide preferential treatment for certain firms or industries in the form of lower interest costs for tax-exempt financing. In the case of pollution control financing, however, it is important to recognize the real economic versus the financial forces that are at play. The real economic decision to allocate productive resources to pollution control activities is mandated by a public policy decision. There is a fixed amount of this activity that will occur under a given interpretation of that policy. Once these resources are committed, the major economic reallocation is completed. The installation of pollution control facilities mandated by federal law does not increase a firm's productive capacity, and thus would not be economically attractive to a company which could expect no financial return on its investment. There would be no economic incentive, therefore, for a rational company to divert any of its resources to pollution control. It follows, then, that the implicit government subsidy through PCIDBs is not likely to divert any more capital than is necessary to meet federal standards, and that this diversion is due to the policies requiring installation of the equipment, not the availability of a particular form of financing.

The main issue then becomes the relative and absolute effects which occur in the financial markets, in connection with the financing of these investments. The provision of tax-exempt financing has the effect of distributing a portion of the cost of pollution abatement over all taxpayers, rather than recovering it solely from the purchasers of the products of the polluting firms. Simply put, the elimination of PCIDBs may prompt the affected industries to raise their prices for electricity, steel, paper, chemicals and other products using these materials, to recover the higher interest costs of non-tax-exempt debt. Public policy has determined that these industries and their customers should not bear the entire burden of meeting stiffer environmental standards.

*Impact on the bond market.*—Coopers & Lybrand and Data Resources independently analyzed the impact of PCIDBs on the financial markets. Despite the use of two dissimilar methodologies, the empirical results are remarkably similar. This section discusses the two firms' analyses of the implications for the financial markets.

The Coopers & Lybrand evaluation looks at the aggregate impact of PCIDBs on the bond market and then asks whether there are any theoretical/empirical reasons to believe that a particular market segment would be differntially affected by PCIDBs. This analysis concludes that in the aggregate, the impact on the overall cost of capital would be very small. Yes, the presence of PCIDBs in the municipal bond market does have an effect on all capital costs. However, this effect is felt by all participants in the financial markets, and the specific impact on the tax-exempt market is small. Coopers & Lybrand recognizes that the financial markets do not instantanously adjust to these market equilibrating forces, and believes that given the magnitude and efficiency of the capital markets in the U.S., the effects of arbitrage work very rapidly and that the "short-run" is not of sufficient duration for these interim adjustment positions to be of concern. There are three important reasons for this conclusion:

*Small PCIDB volume.*—Over the past 10 years, PCIDBs have averaged approximately 10 percent of total new tax-exempts issued. By the end of calendar year 1982, PCIDBs comprised less than 6 percent of outstanding tax-exempt notes and bonds, 1.5 percent of all outstanding privately held federal, state and local government debt, and less than 1.5 percent of long-term corporate debt. (See Table 4). At that time, the value of PCIDBs outstanding was approximately $26 billion. This is less than 0.5 percent of all privately held capital in the economy. The minimal incremental demand for capital attributable to PCIDBs does not significantly affect this vast market.

*Market Forces.*—Before the existence of PCIDBs, a vast array of forces was at work in the capital market. These forces incorporated differentials in the rates of return, risk, maturities and tax effects of all financial instruments. The presence of a small volume of PCIDBs has little material impact on these differentials. What impact there is spread over all markets and, as a result, is virtually negligible.

*Effects of Arbitrage.*—The impact of PCIDBs will be felt in all markets. Assuming the existence of an efficient capital market, that information is free and readily available to all and that investors behave rationally, any increase in the demand for capital in any part of the capital market will be spread over all segments through the actions of arbitragers. Therefore, while an increase in the demand for tax-exempt financing will initially have the effect of raising the yield on tax-exempts, such a tendancy will raise the return to tax-exempts relative to other instruments, making the latter less attractive. Investors will shift quickly from less to more attractive instruments until they ultimately raise the return on all market instruments.

Thus, the incremental demand for capital to finance legislatively-mandated pollution control facilities will have the effect of raising interest rates on municipal bonds. However, the effect would be nearly the same if the same amount of capital were raised through taxable debt. At market equilibrium, the only difference between interest rates for taxable and tax-exempt debt will be the tax effect for investors.

### TABLE 4.—PCIDB'S AS A PERCENT OF OTHER DEBT INSTRUMENTS

[Dollars in billions]

| | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | Outstanding December 31, 1982 |
|---|---|---|---|---|---|---|---|---|
| State and local boards and notes (net of refundings, maturities and sinking fund purchases) | 17.6 | 28.9 | 32.5 | 27.9 | 33.0 | 32.2 | 51.9 | 451.1 |
| PCIDB's | 2.1 | 3.0 | 2.8 | 2.5 | 2.5 | 3.9 | 6.1 | [1] 26.0 |
| Total Government debt | 90.9 | 104.4 | 115.1 | 105.3 | 151.5 | 155.2 | 267.7 | 1,682,1 |
| Long-term corporate debt | 109.4 | 144.3 | 150.4 | 148.5 | 121.5 | 103.7 | 57.8 | 1,857.9 |
| Total demand for credit | 255.1 | 348.8 | 408.2 | 397.3 | 349.4 | 408.7 | 399.4 | 4,889.7 |
| Percent: | | | | | | | | |
| PCIDB's as a percent of State and local bonds and notes | 11.9 | 10.3 | 8.6 | 8.9 | 7.6 | 12.1 | 11.8 | 5.6 |
| Total Government debt | 2.3 | 2.9 | 2.4 | 2.4 | 1.7 | 2.5 | 2.3 | 1.5 |
| Long-term corporate debt | 1.90 | 2.1 | 1.9 | 1.7 | 2.1 | 3.8 | 10.6 | 1.4 |
| Total demand for credit | .8 | .9 | .7 | .6 | .7 | 1.0 | 1.5 | .5 |

[1] Estimated.

Source: Salamon Brothers, 1983 Prospects for Financial Markets, The Bond Buyer (PCIDB volume).

### TABLE 5.—PCIDB INTEREST RATES COMPARED TO MUNICIPAL AND CORPORATE UTILITY BONDS

[Percent]

| | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 |
|---|---|---|---|---|---|---|---|---|---|
| PCIDB's/AA/25–30 year [1] | 5.68 | 6.98 | 7.44 | 6.31 | 5.81 | 6.37 | 6.81 | 8.86 | 10.71 |
| CO Bonds/A/20 year [2] | 5.22 | 6.25 | 7.10 | 6.56 | 5.67 | 6.04 | 6.52 | 8.58 | 11.33 |
| Corporate utility/AA/29/year [1] | 7.83 | 9.41 | 9.45 | 8.67 | 8.33 | 9.09 | 10.24 | 13.14 | 16.25 |

[1] Moody's Bond Report.

[2] The Bond Buyer.

Data Resources constructed a model of the tax-exempt bond market in order to estimate the effects of PCIDBs on tax-exempt interest rates and the volume of tax-exempt borrowing for traditional purposes. Over time, tax-exempt interest rates move sympathetically with taxable rates, since both tax-exempt and taxable rates are influenced by the same financial conditions. Tax-exempt rates are lower because of the advantage of tax-exemption to the holder. The spread between the tax-exempt rate and the taxable rate will equal one minus the marginal tax rate of the marginal buyer of tax-exempt issues:

$$r_e=(1-t_b^*)r_t$$

where:

$r_e$—tax-exempt rate

$r_t$—taxable rate

$t_b^*$—the marginal tax rate of the buyer who switches from taxable to tax-exempt issues

This marginal buyer is indifferent between purchasing tax-exempt and taxable bonds of the same term and quality; for the marginal buyer, the after-tax returns are equal. Individuals with marginal tax rates above $t_b^*$ will prefer to hold only tax-exempts, while individuals with marginal tax rates below $t_b^*$ will prefer to hold taxables. The value of $t_b^*$ that equilibrates tax-exempt yields depends upon the relative quantities of taxables and tax-exempts placed in the market. Most purchases of tax-exempts are by households, bond funds, commercial banks, and fire and casualty insurance companies. For example, these three sectors held 89 percent of the net new issues in 1981. Commercial banks purchase tax-exempt once they have met their commitments to other borrowers, if they have taxable income to shelter. The demand of fire and casualty companies is highly unstable, depending on their cash flow needs. As a result, the household sector can be considered the residual absorber of tax-exempts. Tax-exempt interest rates will adjust relative to the taxable interest rate to attract enough buyers from the household sector to clear the market.

As the volume of tax-exempts increases, more household investors in lower tax brackets must be drawn into the market, thereby reducing the marginal tax rate, $t_b^*$ that equilibrates the market. As a result, tax-exempt rates will rise relative to taxable rates, causing the spread between tax-exempt and taxable rates to decrease. On the other hand, if the supply of tax-exempts declines, the equilibrating value of $t_b^*$ will rise as fewer tax-exempts are purchased by households. As a result, tax-exempt rates will fall relative to taxables, and the spread will widen.

A fully specified model of the municipal bond market would include nine equations: (1) a supply equation for state and local government bonds; (2) a supply equation for PCIDBs; (3) a supply equation for all other IDBs; (4) a demand equation for the purchases of fire and casualty insurance companies; (5) a demand equation for the purchases of commercial banks; (6) a demand equation for the purchases of all other institutions; (7) a market clearing interest rate equation for tax-exempts; (8) an interest rate equation for PCIDBs, and (9) an interest rate equation for all other IDBs. The last two equations capture the interest rate premia on IDBs from their segmentation from the rest of the tax-exempt market. Appendix A reviews earlier models of the tax-exempt market and describes the estimation and simulation of the DRI tax-exempt bond market model.

The empirical results derived from the municipal market model constructed by DRI indicate that a $1 billion increase in state and local borrowing, whether it is PCIDBs, IDBs, or general obligation bonds, raises state and local borrowing rates by about two basis points relative to comparable taxable rates. This result is only about one basis point higher than the findings of Kormendi and Nagle (1981), but is much lower than the increase of four to seven basis points reported in Petersen (1979).

The modelling results also suggest that the sensitivity of the supply of state and local obligations is relatively interest-inelastic with respect to variations in state and local borrowing rates. A one basis point increase in state and local borrowing would lower state and local borrowing by at most $10 million.

### *Impact on the Treasury*

The Treasury Department has estimated that the tax revenue loss attributable to PCIDBs was $720 million in 1981 and $825 million in 1982. As stated in the 1984 Budget Special Analyses, these estimates "are not equivalent to estimates of the increase in Federal receipts that would accompany the repeal of tax subsidy provisions." Thus, these estimates actually overstate the impact of PCIDBs on the Federal tax receipts, since there are offsetting revenues associated with PCIDBs as well as "tax expenditures."

Coopers & Lybrand and Data Resources independently estimated the federal revenue losses from PCIDBs. Varying assumptions underlie the estimates. Therefore, the two approaches result in different estimates of the tax revenue loss to the Treasury.

Coopers & Lybrand's estimate of the actual loss in Federal receipts takes into consideration the offsetting factors associated with PCIDBs. The most important is the increase in tax revenues due to reduced tax deductions for firms using lower-interest PCIDBs rather than taxable debt to finance pollution control facilities. In view of the legal requirements that firms install these facilities, it can be assumed that firms would use taxable debt to finance the required modification if PCIDBs were not available. The costs to industry of using taxable debt would be reduced by the increase in interest tax deductions, which would reduce the taxes paid by a percentage equivalent to the PCIDBs-user firms' effective tax rate.

Since no composite estimates are available of the overall tax rate for all bond issuers, Coopers & Lybrand used the average tax rate for electric utilities—the major industry using PCIDB financing—to estimate the offsetting gains in tax revenues attributable to this factor. The average tax rate for electric utilities has been approximately 34 percent in recent years. Applying this percentage to the Treasury's revenue loss estimates would reduce those estimates to approximately $475 million in 1981 and $545 million in 1982. These revised estimates should constitute an upper bound on the tax revenue loss attributable to the tax-exemptions for PCIDB interest.

Data Resources' estimates of the federal revenue losses from PCIDBs are developed from a multi-asset model developed by Harvey Galper and Eric Toder. In this model, the only assets are tax-exempt and taxable bonds. Issues of tax-exempt PCIDBs displace taxable debt used to finance investment. While the government no longer collects tax revenue on the displaced taxable debt, it recovers some of the lost revenue because firms who use PCIDBs claim smaller interest deductions. The lost tax revenue on the displaced debt is considered the gross loss to the government, while the net loss includes the offset of lower interest deductions. Appendix B discusses this model and Data Resources' determination of the tax revenue impacts of PCIDBs.

The empirical results derived by Data Resources indicate the federal revenue losses from PCIDBs range from $700 million to $1 billion in 1982. Elimination of all PCIDBs issued after 1982 would raise revenues by $80 million in 1983, rising to $370 million in 1985. Assuming a liberal amount of economic feedback from the lost investment stimulus, the revenue gain would be $70 million in 1983, rising to only $250 million in 1985.

If PCIDBs were eliminated, most firms would seek financing through taxable debt. However, the Treasury would not necessarily recover the revenues lost in tax benefits to the bondholders. If investors replaced their investment in PCIDBs with fully taxable investments, the Treasury's loss would be minimized. However, a myriad of tax shelters is available to investors at different levels of risk and return. The rational investor can be expected to find the means of obtaining the return he desires at a level of risk he is willing to incur. To the extent investment in PCIDBs is replaced by investment in other tax-exempts or tax shelters, the loss to the Treasury remains the same. Unfortunately, given the small volume of PCIDBs outstanding, the data available makes it difficult for us to comment on the precise pattern of activity at the margin. It is likely, however, that most investors would find other means of sheltering their income if tax-exempt PCIDBs were not available.

### CONCLUSION

PCIDBs represent a small percentage of all tax-exempt bonds sold, and a much smaller percentage of tax-exempt bonds outstanding. They are used only to pay for construction of pollution control facilities required to bring certain industries into compliance with federal environmental law. Because the tax laws permit the sale of PCIDBs at the lower interest rates associated with tax-exempt financing, PCIDBs represent a partial federal subsidy to these industries. The presence of these bonds in the capital market has the effect of raising interest rates. The effect is minimal because of the low volume of PCIDBs sold. PCIDB use results in a net tax revenue loss to the Treaury. If tax-exempt PCIDBs were eliminated, it is likely that most investors would find other means of sheltering their income. To the extent investment in PCIDBs were replaced by investment in other tax-exempts or tax shelters, the loss to the Treasury would remain the same.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Let me ask a question of Mr. Potts.

Let's assume that Congress decides that some limitation on small-issue IDB's was necessary. In your opinion, is a State-by-State cap the best approach? And, if so, how would you design the cap? If not, what other method of limiting the use of small-issue IDB's would you suggest?

Mr. POTTS. Well, instead of limiting the use I would raise the limit from $10 million to $15 million, to keep pace with inflation. You need $15 million today to be where you were in 1968 with the $5 million limit. So I would favor no further restrictions.

I would favor the expansion of the use of IDB's, and I think that any further restrictions would make the program so burdensome and so laden with all kinds of restrictions that it would be practically unworkable and unusable in the main part.

Senator **Durenberger**. Well, let me ask you a different question, though we are going to run short of time today.

You have made the argument in your written statement that we ought to continue the small-issue IDB's because communities need to attract businesses that can serve as a magnet for other businesses. If a community doesn't have to commit any of its own funds, how is it that one community attracts a business over another community? Haven't we just created a situation where all communities are offering IDB's, and therefore we have lost the incentives that were a part of the original rationale?

Mr. **Potts**. Well, most of the communities already make contributions, Mr. Durenberger. They do this in the form of tax concessions of one kind or another, or special help in terms of road access and things like that. So they are already making contributions.

Now, I think one of the values of the program now is that every community can use it; it's not something that is used only, let's say, by Southeastern States or Southern States to attract industry away from the Midwest. So the program is available to all companies that want to use it—all States, and all communities.

Senator **Durenberger**. Mr. Wegmiller, is there an end at all to tax-exempt bond financing? You are well aware that we are moving into a new era of prospective pricing and competition and operating margins for hospitals are going to be key there. Is there ever a period of time when we are going to be able to phase out tax-exempt bond financing for hospitals?

Mr. **Wegmiller**. I think that the difficulty in ever phasing out tax-exempt bonding is the difficulty of not-for-profit organizations to move to another kind of capital access, any one of which is more than likely going to be more expensive. And as you point out in your question, we are entering an era of limited resources in health care. Everyone understands that, certainly. The health care providers at the same time look at a source of capital that is going to be more expensive. It doesn't add anything to the quality of health care, the betterment of the facilities, or more personnel.

It is for the foreseeable future very difficult to envision a time when tax-exempt financing isn't going to be needed by not-for-profit hospitals.

The **Chairman**. Senator Long.

Senator **Long**. No questions, Mr. Chairman.

The **Chairman**. I have no questions, except to indicate the tax-exempt bond issuance increased from 30 billion to 85 billion, almost a threefold increase, from 1975 to 1982. Over that same period, small-issue IDB's increased from 1.3 billion to over 12 billion, a tenfold increase. Private-purpose bonds generally have increased from 20 percent of the total tax-exempt market to over 50 percent. So I think we need to look at this area, as we are doing in this area and others.

We have been mandated by the Congress to find $73 billion in revenue, and we intend to look at everything. I am not certain what might be the final outcome of that dead cat they gave us, but we appreciate your testifying.

Mr. POTTS. Mr. Chairman, may I give you a figure that is related to what you have just said?

The Public Securities Association has just released some data on the first quarter of 1983, and their figures show that the volume of small issues was 53 percent lower than for the same period in 1982. Those actual figures are $310 million of small issues in the first quarter of 1983, as compared to $668 million in the first quarter of 1982. In other words, it would appear that the restrictions enacted in TEFRA last year are beginning already to take hold. And the point I made in my testimony was that Congress ought to at least give those restrictions a year to work their way through the system, and then determine whether further restrictions are needed.

The CHAIRMAN. Thank you very much.

Our next witness will be Senator Durenberger. I might say to the witnesses, we had a little delay because we had a vote at 10 a.m., so we lost about 30 minutes, and we are going to try to finish by noon or a little after, so we are going to ask all witnesses to summarize their summaries. [Laughter.]

Senator Durenberger.

Senator DURENBERGER. I thank my colleague. I will endeavor to summarize the summary of my summary, if that is possible, since all of my colleagues on this committee have a more detailed explanation of a proposal that I put forward relative to the deductibility of State and local taxes.

As you will recall, Mr. Chairman, last year one of the so-called reform issues that we considered as we were approaching TEFRA was the elimination of the deduction for State and local sales and personal property taxes. And I assume that, as we go through this business of examining "who to feed the cat" that you referred to, there is going to be some serious scrutiny of this issue.

So let me say at the outset, I believe that any assault on the deductibility of State and local taxes solely as a means of raising more Federal revenue is misdirected and ill advised. This doesn't mean, however, that the deduction of State and local taxes should remain exempt from examination as this committee approaches genuine tax reform.

I think there are three basic questions that this committee should address as it goes about determining the future treatment of State and local taxes in the Federal tax code.

First, is the deduction of State and local taxes an efficient Federal subsidy for State and local government? In this context, I think of efficiency as the amount of benefit realized out of the State and local end, compared to the dollar of revenue lost or expended here in the Federal end.

Economists have looked at this whole issue, and when they look at the revenue value to State and local governments, of the Federal Government giving tax relief to taxpayers through the deductibility of State and local taxes, they discover that it's a very inefficient way to subsidize these governments. They estimate—and this is sort of a consensus estimate—that for every dollar of Federal revenue foregone because of deductibility, State and local governments receive only about 21 cents in the form of increased revenues over what they would have realized without deductibility.

It is further estimated that, if the deduction is not totally eliminated but is limited in a careful manner, for each dollar in deductions taken away, State and local governments will realize a decrease in revenues equal only to about a dime. In each of those cases, that's sort of the psychological impact on the taxpayer.

The second question this committee should address is suggested by the answer to the first: Is it possible to limit the deductibility of State and local taxes and replace this indirect subsidy with a more efficient subsidy? And the answer to that, in my opinion, is a resounding yes. The most efficient of all direct Federal assistance to State and local governments is a program this committee will reauthorize this afternoon—general revenue sharing.

It is estimated that for every dollar Congress appropriates for revenue sharing, 99 cents finds its way into the hands of State and local officials and only 1 cent gets lost to administration.

So, limiting the deductibility of State and local taxes and returning the increased Federal revenues to State governments through a new State revenue-sharing program would have enormous efficiencies. Instead of 10 to 20 cents of every Federal dollar finding its way back to State and local government, 99 cents on the dollar would be available.

This then leads us to our third and final question, and that is: What is the best way to limit the deductibility of State and local taxes?

To answer this, let me begin with the worst possible approach, and that is selectively repealing the deductibility of a single tax such as the sales tax.

Nationwide, in 1980, the sales tax accounted for 16 percent of all deductions for State and local taxes, but that ranged from less than 1 percent in Oregon, which has almost no qualifying sales tax, to 46 percent in the State of Louisiana. So, if sales tax deductibility were repealed, the additional Federal revenues would come mainly from residents of States like Louisiana that relied heavily on the sales tax as an important revenue source and very little from residents of States that levied no sales tax.

In addition, the Federal Government, by this kind of selective action, would be encouraging States to shift reliance off the nondeductible taxes onto other taxes that remain deductible, such as the real property tax.

A major issue in designing a limit on deductibility is how much it will cost State and local governments in lost revenues. By this standard, selective repeal of the sales tax is also an undesirable approach. Of the several major approaches I have examined, selective repeal of the sales tax would produce the largest revenue losses to State and local governments.

I have looked carefully at possible ways to limit deductibility, and have come to the conclusion that the best way to treat the four remaining taxes eligible for deduction—that is, income, sales, real, and personal property—is to combine them into one pool and to place a floor on the total amount that may be deducted. This floor should be expressed as a fixed percentage of a taxpayer's adjusted gross income, to avoid regressivity. Only taxes in excess of the floor amount would remain eligible for a deduction, while taxes paid up to the floor would now be subject to the Federal income tax. This approach has several desirable attributes:

First, it is clearly not regressive. It does not skew State and local tax decisions in favor or against any particular tax. It raises revenues more uniformly among all the States, and it produces the least loss in State and local-owned source revenues.

The Congressional Research Service has estimated that for each dollar collected by the Federal Government through this limitation, State and local governments would improve tenfold if the dollars raised through this limitation were returned directly through State revenue sharing.

Mr. Chairman, I would say this is something approaching genuine tax reform. It improves the Federal income tax by broadening the tax base, it limits the loophole from which only 30 percent of all Federal tax returns would benefit, and at the same time it does not neglect the profound policy implications such a change holds. Most importantly, it does not merely seek increased Federal revenues while hiding behind the rhetoric of tax reform.

Before I submit to your questions, let me introduce Miss Nonna Noto, who is a senior analyst with the Congressional Research Services, who, with her colleague Dennis Zimmerman, just completed a comprehensive report on this question of State and local tax deductibility for the Governmental Affairs Committee.

I have a written statement that I would like to submit on their behalf, and she would be available to back me up if you have any questions.

The CHAIRMAN. Senator Long.

Senator LONG. No questions.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. No questions, thank you.

The CHAIRMAN. I have no questions at this time. As you know, it is a matter we looked at last year, and I think we probably chose the worst option—trying to just repeal or take care of one type of tar. So this may be a fresh approach.

I am not certain about the revenue implications or the possible regressivity. You have addressed those, I assume, with the floor.

Senator DURENBERGER. Right.

The CHAIRMAN. But it is something we will want to discuss, I assume, as we get into the nitty-gritty of trying to put the package together. We thank you for your assistance, too.

Senator DURENBERGER. Thank you, Mr. Chairman.

The CHAIRMAN. Now we have a panel consisting of Kenneth Dickinson, president of Dickinson, Logan, Todd & Barber, on behalf of the Mortgage Bankers Association of America; Scott Slesinger, executive vice president, National Apartment Association; and Stephen Smith, executive committee, Coalition for Low and Moderate Income Housing.

Again, if I could encourage the witnesses to summarize their statements so we might have time for questions.

## STATEMENT OF KENNETH D. DICKINSON, PRESIDENT, DICKINSON, LOGAN, TODD & BARBER, INC., RALEIGH, N.C., ON BEHALF OF THE MORTGAGE BANKERS ASSOCIATION OF AMERICA, WASHINGTON, D.C.

Mr. DICKINSON. Mr. Chairman, I am Kenneth Dickinson. I am president of Dickinson, Logan, Todd & Barber, a mortgage banking firm headquartered in Raleigh, N.C. I am also a past chairman of the Mortgage Bankers Association of America's Income Property Committee. As you are aware, MBA is a trade association of the Nation's mortgage banking industry.

The provisions of the Economic Recovery Tax Act of 1981 and the Tax Equity and Fiscal Responsibility Act of 1982 responded to high inflation by providing desirable tax treatment to restore the balance of incentives for long-term real estate investments. MBA urges this committee to recommend that no changes be made to those provisions in the Federal income tax law that encourage the ownership and development of real estate.

The staff of the Federal Reserve Board completed a study in 1981 relative to the problem of capital formation. The Federal Reserve Board research confirmed that a tax system in effect in 1980 and 1981 favored shorter term over longer term investments. The most prominent suggestion as to how tax law could be rewritten was the Accelerated Cost Recovery System which Congress incorporated into the Economic Recovery Tax Act of 1981. Expected tax treatment is of primary importance in estimating the profit or loss from a real estate investment. To the extent that such changes are unfavorable to real estate, they prevent some new projects from being built.

There has been discussion that the proper period for depreciation of real estate structures should be 20 years rather than the current 15 years. The difference between a 20-year depreciation period and a 15-year depreciation period will make some proposed construction projects uneconomical, of course; but the very changing of the depreciation laws so soon after they were established will have a widespread negative effect. Unless investors can be reasonably certain that Congress recognizes the importance of a stable investment environment and does not intend to tinker frequently with the tax code as it affects real estate, the desirability and necessary development of real estate structures will not be financed.

The rate of return on multifamily projects is limited because rent levels are not adequate in the face of expensive debt service and increasing operating expenses. Current law provides that multifamily buildings may be depreciated at a rate in excess of straight line, with more favorable recapture rules than other income property. MBA urges that the committee make no recommendations to weaken these provisions.

MBA supports enactment of S. 137, the Housing Financing Opportunity Act of 1983, which would extend the tax-exempt status of revenue bonds for housing, as long as such bonds are targeted to the low income, the elderly and handicapped.

Several other provisions of current tax law recognize that, in addition to shelter, a house or condominium serves as the repository of the individual savings of many Americans. MBA urges the committee to recommend that no changes be made in the tax law to discourage homeownership.

We appreciate this opportunity to testify, and we would be happy to answer any questions.

[The prepared statement follows:]

## STATEMENT OF KENNETH D. DICKINSON, PRESIDENT, DICKINSON, LOGAN, TODD & BARBER, INC., RALEIGH, N.C., ON BEHALF OF THE MORTGAGE BANKERS ASSOCIATION OF AMERICA

Mr. Chairman and Members of the Committee, my name is Kenneth D. Dickinson. I am President of Dickinson, Logan, Todd & Barber, Inc., a mortgage banking firm headquartered in Raleigh, North Carolina. I am also a past chairman of the Mortgage Bankers Association of America's (MBA) Income Property Committee. MBA[1] is the trade association of the Nation's mortgage banking industry. Accompanying me are Burton C. Wood, MBA's Legislative Counsel, and William E. Cumberland, MBA's General Counsel.

We appreciate the opportunity to appear before you today to express our views on those provisions in the Federal income tax law that encourage the ownership and development of real estate. As has been demonstrated in the past few years, high inflation rates discourage investment in real estate, which is a relatively long term asset, compared with other types of property, such as equipment. The carefully developed real estate related provisions of the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) responded to recent high inflation by providing desirable tax treatment to restore the balance of incentives for long term real estate investments. MBA believes that the inflationary pressures of the past decade are still present and that the real estate related tax provisions enacted and ratified by Congress in 1981 and 1982 are still appropriate and needed. Therefore, MBA urges this Committee to recommend that no changes be made, at the present time, to those provisions in the Federal income tax law that encourage the ownership and development of real estate.

The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership is comprised of mortgage originators, mortgage investors, and a variety of industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios.

### INFLATION PRESSURES

MBA is deeply concerned and disappointed that the President's budget for 1984 has failed to produce substantial cuts in the Federal deficit. The huge and unacceptable deficits projected for 1984, 1985, and 1986 mean the Government will continue to absorb increasing amounts of credit that the private sector sorely needs to ensure economic recovery.

The devastating effects of the deficits cannot be overemphasized. Protracted deficits will severely inhibit, if not prevent, the economic recovery; threaten to rekindle rapid inflation; and aggravate the fears of consumers, lenders, and investors, who understand too well that the existence of deficits over long periods means that obtaining affordale credit will become more difficult, if not outright impossible.

MBA has called upon Congress to attack seriously the problem of too rapid growth in the Nation's defense expenditures and in entitlement programs, including Social Security. Only after everything has been done to curtail the growth in spending in these areas, should tax increases be considered. By substantially reducing the Federal deficit over the next several years, Congress can do much to restore confidence that a sustainable noninflationary recovery in the private sector of the American economy is likely.

---

[1] The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a variety of industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include: Mortgage Banking Companies; Mortgage Insurance Companies; Life Insurance Companies; Commercial Banks; Mutual Savings Banks; Savings and Loan Associations; Mortgage Brokers; Title Companies; State Housing Agencies; Investment Bankers; Real Estate Investment Trusts. MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500.

### THE IDEAL TAX SYSTEM

An economically sound tax system should be based on two principles. First, such a system should be neutral, that is, one where the investment decisions made are the same ones that would occur had there been no tax at all. Under a neutral tax system, the pre-tax return would be independent of the furability of the investment, and the tax would not alter the mix of investments. Second, a tax system should be equal, that is, one where the same effective tax rates are levied on all types of assets.

A perfectly neutral and equal tax is not likely to exist within the U.S. Tax Code. Most tax changes over the last thirty years have been undertaken to achieve some policy objectives or to help some specific group. A primary example is the mortgage interest tax deduction for homeowners. It is not to be expected that the Congress can or even should pass a perfectly neutral or equal tax law. However, reasonable standards of tax neutrality are a significant measure of a successful tax law.

### EFFECTS OF INFLATION ON REAL ESTATE INVESTMENT

A weakened dollar and a reduced rate of productivity increases in the U.S. economy, during the 1970s, focused public attention to the problem of capital formation in the United States. As a result, the staff of the Federal Reserve Board (FRB) completed a study of the problem in 1981. The study reported that, since 1962, the composition of investment had shifted away from investment in structures toward investment in shorter-lived assets, such as equipment. This trend toward shorter-term investing was compounded by lower rates of capital formation in the United States, relative to other industrialized countries. The study also found inefficiencies in the allocation of scarce capital stock in the U.S. economy. In addition, the FRB research confirmed that the tax system in effect in 1980 and 1981 favored shorter-term over longer-term investments. These factors resulted in lower rates of capital formation than would otherwise be the case. Moreover, inflation and the tax laws did not have the same effects on all types of capital assets. Inflation acted as a tax by reducing the value of depreciation deductions and by causing taxes to be levied against nominal rather than real (inflation-adjusted) capital gains.

---

## PROVISIONS RELATING TO INCOME-PRODUCING PROPERTY

### THE BASIC CHANGE: THE ACCELERATED COST RECOVERY SYSTEM (ACRS)

The conclusion of the 1981 FRB study of capital formation was that the existing capital stock seriously misallocated. The report suggested a variety of ways in which tax law could be rewritten so as to direct the flow of investment more efficiently. The most prominent among these suggestions was the accelerated Cost Recovery System (ACRS). Acceleration of the rate at which capital can be depreciated increases the discounted present value of the depreciation deductions to recognize more accurately the depreciation of capital as a current cost of doing business. Accelerated depreciation mitigates the overall bias of the tax system against business capital. Additionally, the ACRS is easier to administer than the previous system of assigning a "useful economic life" to hundreds of different kinds of equipment, vehicles, and structures.

The ACRS made dramatic changes in the way assets may be depreciated for tax purposes. These changes greatly simplified and streamlined the depreciation process. The most basic change was the replacement of the useful economic life concept. In its place, three basic time periods were set up, one for each category of asset. Thus, autos and light trucks could be depreciated over three years, equipment over five years, and structures over fifeen years. Congress incorporated the ACRS in the Economic Recovery Tax Act of 1981.

The question of whether the new change meets its objectives, and whether, in doing so, it is reasonably neutral and equal is not yet subject to an answer. A full evaluation of the economic effects of ACRS must wait until we have more data on investment flows and allocation. However, in discussing whether ACRS should be changed or allowed to remain as it is, some general comments can be made.

Expected tax treatment is of primary importance in estimating the profit or loss from a real estate investment, and projects planned since the implementation of ACRS have relied on these new depreciation rules. In contemplating the public policy implications of changing ACRS, it must be remembered that the feasibility of new projects and the market value of existing property will be affected, either favorably or unfavorably, by any major changes in tax treatment. Such changes create windfall gains or losses for real estate investors and owners who are providing rental housing, office, retail, and wholesale space, warehouses, and other facilities needed by a growing and mobile economy. To the extent that such changes are unfavorable to real estate, they prevent some new projects from being built, and they inflict losses on project owners who already have commited their funds. The losses caused by such changes in tax treatment must be passed along to renters and consumers, or are suffered by property owners, depending on market conditions.

Because of the one-to-three year planning and construction period required for most commercial real estate projects, plans must be based on assumptions about future market conditions, costs, revenue, and tax treatment. Frequent changes in tax treatment add to the uncertainty inherent in planning a real estate project, imposing a cost that must ultimately be paid through higher rents or reduced equity. Although tax treatment may need to be changed to reflect public policy decisions, it should be recognized that changes impose costs on the economy, forcing a reallocation of resources and prices. Too frequent changes can disrupt the market by introducing an additional element of uncertainty and risk, adding to costs.

There has been some discussion that the proper period for depreciation of real estate structures under ACRS should be 20 years rather than the current 15 years. The difference between a 20-year depreciation period and a 15-year depreciation period will make some proposed construction projects uneconomical, of course, but the very changing of the depreciation laws, so soon after they were established, will have a widespread deleterious effect that cannot be measured by analysing a hypothetical real estate project using 20 and 15 year alternatives. Unless investors can be reasonably certain that Congress recognizes the importance of a stable investment environment and does not intend to tinker frequently with the tax code as it affects real estate, the desirable and necessary development of real estate structures will not be financed.

### INDUSTRIAL REVENUE BONDS

Although mortgage bankers participate in financing real estate structures using industrial revenue bonds, MBA does not support the Federal income tax exemption for financing private industrial income-producing facilities, except where such financing is used to meet city, state, or Federal environmental requirements, or is used to finance federally or state-assisted multifamily housing that is targeted toward meeting the needs of the disadvantaged, specifically low income families, the elderly, and the handicapped.

### DEDUCTION OF CONSTRUCTION PERIOD INTEREST AND TAXES

Under current law, interest and taxes paid during the time of construction must be amortized over ten years rather than allowed to be deducted on a current year basis. This provision works a hardship on investors, particularly during times of extremely high interest rates. The construction period expenses for interest and taxes are a significant element in the cost of a real estate project. The industry guideline is that construction period interest paid will total roughly the interest rate paid times one half the cost of the building. Thus, for example, a $20 million structure, taking two years to construct, with 14 percent construction financing will incur a construction period interest expense of roughly $1.4 million. Requiring this expense to be capitalized and recovered over ten years, in inflationary times, means that investors not only must wait for the tax relief, but also will receive it in dollars that have less purchasing power than those invested during the construction period. MBA urges the Committee to recommend that the deduction of construction period interest and taxes be allowed as an expense in the year they are incurred.

### DEDUCTION OF PRE-OPENING EXPENSES

Owners of commercial facilities, and to a lesser extent, multifamily projects incur expenses prior to the time they are operating as a business. The Internal Revenue Service, by regulation, has required these expenses to be capitalized rather than deducted as current expenses. Start-up expenses are not acquisition or construction expenditures of the type that are traditionally amortized. They are necessary and ordinary business expenses, even though they are incurred prior to the time the business is a formally operating entity. MBA urges the Committee to recommend that pre-opening business expenses be specifically defined as currently deductible trade or business expenses.

### INTEREST ON INVESTMENT INDEBTEDNESS

The limitation on deduction of interest on investment indebtedness by individuals and partnerships in the current law can impede the development of real estate projects. Successful real estate developments are often highly leveraged. During times of high inflation, with interest rates at record levels, debt service may exceed income by a wide margin for the initial years of operation. The cost of the money used to finance the acquisition of real estate should be recognized as a necessary and ordinary business exense. MBA urges the Committee to recommend removal of the limit on the deduction of interest investment expense by individuals and partnerships.

### SPECIAL TYPES OF STRUCTURES

*Multifamily.*—There are many reasons why investment in the production of multifamily housing is increasingly less attractive. However, the reasons can be summed up by saying that the rate of return is limited because rent levels are not adequate in the face of prohibitively expensive debt service and constantly increasing operating expenses. As a result, rental housing is often not a profitable venture for investors. Without compensating factors, this state of affairs will continue and we will find ourselves in the midst of an increasingly severe housing shortage, particularly for low- and moderate-income families. In recognition of the special needs for encouragement of investment in these structures, current law provides that multifamily buildings may be depreciated at a rate in excess of straight-line, with more favorable recapture rules than other income property. Also, a special five year amortization period is allowed for the rehabilitation of housing for low income families. MBA urges that the Committee make no recommendations to weaken these provisions.

*Historic properties.*—In order to encourage the preservation of historic properties, certain special deductions and credits are allowed for the preservation and rehabilitation of structures deemed to be historic. Older cities, especially, can and do benefit from the tax law treatment available to owners and developers to recycle older, historic properties. MBA urges that the Committee recommend that historic properties continue to receive special favorable treatment under the tax law.

### MISCELLANEOUS

There are several other provisions in the tax laws that encourage investment in real estate and that MBA urges the Committee to recommend be retained. Profits in real estate should continue to be subject to capital gains treatment, and state and local taxes, including property taxes, should be recognized as ordinary expenses, in the same manner as these items are treated for other types of investments.

## PROVISIONS RELATING TO HOMEOWNERSHIP

### REVENUE BONDS FOR HOUSING

Another major recent development involving Federal tax laws that affect real estate ownership and development is the threatened termination of the ability of states and municipalities to issue revenue bonds for housing.

Mortgage bankers have participated extensively in homeownership programs financed with the proceeds of tax-exempt revenue bonds. When properly administered and properly targeted, revenue bond programs can provide homebuyers with needed financing and mortgage lenders with a new source of business opportunities, without infringing upon markets that can be served without government subsidy.

MBA opposed the use of municipal tax-exempt revenue bonds to fund home ownership when such bonds mushroomed in 1978. The rapid proliferation of these bonds for home mortgages allowed the substitution of public funds for private funds in the marketplace. In addition, they were an inefficient way to deliver governmental help even to those in our society who could not be served adequately by private lenders. Others, too, saw the danger of the apparently limitless use of home mortgage revenue bonds, and in the Mortgage Subsidy Bond Tax Act of 1980 (Subtitle A of the Revenue Adjustments Act of 1980, Title XI of the Omnibus Reconciliation Act of 1980, PL 96-499), Congress provided that the tax-free status of such bonds would expire at the end of 1983.

The Mortgage Subsidy Bond Tax Act of 1980 not only established an expiration date in the future, it imposed other restrictions to be effective until that expiration date. A statewide ceiling was set on the volume on bond issuances; a one percent arbitrage limit was imposed; only first-time homebuyers could be finance; and the maximum purchase price that could be paid using tax-exempt financing was set at 90 percent of average for the area (110 percent in areas of special need). The practical result of these interim restrictions was to prevent the issuance of tax-exempt revenue bonds for housing almost immediately, long before the established December 31, 1983, expiration date.

Recognizing that the restrictions imposed in 1980 were too tight, Congress included provisions in the Tax Equity and Fiscal Responsibility Act (TEFRA) (PL 97-248) to ease the limits. The arbitrage limit was increased to 1.25 percent; the first-time homebuyer rule was given a 10 percent safety-value exclusion; and the sales price limits were raised from 90 percent to 110 percent of average acquisition cost for the area (120 pervent in targeted areas).

The experience of bond issuance under these restricitons indicates that, with limits, revenue bonds for housing can be used successfully. The limits established by the 1980 Act, as modified by TEFRA, may need further tuning to achieve the proper balance between high volume and targetted benefits, but the recent history of the bonds indicates that their use can be controlled and their implicit Federal subsidy can be directed to those who cannot be adequately served by the private market.

Reflecting this recent history, MBA no longer opposes categorically the issuance of home mortgage revenue bonds. Rather, on May 17, 1983, the Board of Governors adopted a revised statement of policy on the subject of tax-exempt bonds for housing, as follows: "MBA supports using municipal tax-exempt bond issues to provide funds for home mortgages, provided such issues are targeted toward meeting the needs of the disadvantaged, that is, the low-income, the elderly, and the handicapped. Further, such programs should be simplified and strict standards applied to make them less costly to homeowners and easier to work with for all participants. Moreover, If used, such programs should only be available to housing finance agencies which allow all types of originators and servicers to participate in all their programs."

Therefore, MBA supports enactment of S 137, the Housing Financing Opportunity Act of 1983, introduced by Senator William V. Roth, Jr. and many co-sponsors. This legislative measure simply would delete the tax exemption exiration date from the Internal Revenue Code by restating Section 103A(b) without the expiration clause. I would not ratify or otherwise endorse the current purchase price ceilings, nor preclude subsequent fine tuning to target the proceeds from revenue bonds toward encouraging homeownership by the disadvantaged, that is, people with relatively low incomes, or who are elderly or handicapped.

Preliminary findings of a study being conducted by the General Accounting Office (GAO) raise a question whether revenue bonds for housing are currently restricted so as adequately to target the proceeds to disadvantaged persons. In its April 18, 1983 report, "The Costs and Benefits of Single-Family Mortgage Revenue Bond: Preliminary Report," addressed to the chairman of the Senate Finance Committee, the GAO found "that most subsidized home loans were not made to low- and moderate-income households in need of assistance, but rather to those who probably could have purchased homes without assistance." Whether the final report will reach the same conclusion remains to be seen, of course, but, if the study does result in evidence that the Federal tax exemption is being used widely for people who are not low income families, handicapped, or elderly, a careful adjustment of the Federal law should be made.

In reviewing the final results of the GAO study, observers should be aware that it was conducted on activity occurring during 1981 and 1982—a period of record increases in home mortgage interest rates and market distortions brought about by these increases, as well as the high rates actually reached. Because of the rapid increase in the cost of financing, the private market was accessible only to a few. Now that home mortgage interest rates have dropped to more normal levels, the private market is again serving moderate-income homebuyers. Whether the states generally will exercise restraint and offer tax-exempt revenue bond assistance only to those disadvantaged people who cannot be served by the private market may not be answered by the study results alone.

### DEDUCTIBILITY OF HOME MORTGAGE INTEREST

Current law allows homeowners to deduct the interest paid on home mortgages, fully and without direct or indirect limit. MBA believes the tax deductibility of home mortgage interest is consistent with this Nation's long-standing commitment to homeownership opportunities for all American families. MBA opposes any restrictions upon this deductibility. Such restrictions could increase homeownership costs at a time when a reduced number of American families can afford to purchase a home. Limitations on interest deductibility would also discriminate against current homebuyers whose interest expenses, due to the high level of prevailing interest rates, are far higher than those of existing homeowners with mortgage loans that carry interst rates below current rates.

Additionally, at a time when our Nation's housing finance markets are being increasingly integrated with the Nation's capital markets, homebuyers would be at a severe disadvantage in the competition of funds of the interest deduction for home mortgages is singled out for restriction.

MBA recognizes that the proposals to limit deductibility directly have been put aside, for a while, in response to the resounding Congressional expression against them in the previous Congress. But indirect attacks on the full deductibility continue to surface. Proposals to cap aggregate non-business interest deductions for an individual, for example, are indirect attacks on the deductibility of home mortgage interest. MBA urges the Committee to reject any attack, direct or indirect, on the full deductibility of home mortgage interest payments.

### MISCELLANEOUS

Several other provisions of current tax law recognize that, in addition to shelter, a house or condominium serves as the repository of the individual savings of many Americans. State and local property taxes are deductible as they would be for any other real estate investment, and a tax must be paid on the profit realized upon the sale of the house, but the profit tax is tempered by the allowance for an exemption of $125,000 for persons nearing or reaching retirement age. This recognition that equity in the home is the foundation of the retirement plan of many older citizens, coupled with the ability to defer any profit-tax while the house, or a substitute, is being used for shelter, allows the home to provide a mixed set of benefits, efficiently and fairly. MBA urges the Committee to recommend that no changes be made in the tax laws to discourage homeownership.

### ENCOURAGING THE AVAILABILITY OF CAPITAL

In a sense the foregoing sections are a discussion of provisions that encourage the direction of capital toward real estate investment. There are several provisions, which are in the current tax law, or which could be adopted, that can encourage the availability of capital in the aggregate.

### INCOME EXCLUSIONS

Currently, individuals are allowed to exclude from taxable income a portion of the dividends and interest they receive each year. Somewhat analogous, corporations are taxed at a lower rate on the first $100,000 in profits annually. Each of these reductions of tax tends to encourage the small, marginal investor to dedicate capital to investment, rather than to expend funds for consumption. MBA has consistently supported responsible efforts to encourage capital formation, and, therefore, MBA urges the Committee to recommend that the current income inclusions be expanded rather than restricted.

### QUALIFIED PENSION PLANS AND IRAS

There are a group of tax law provisions that are slowly becoming of particular importance to the development of real estate, and show promise of becoming more important. The ability to defer taxation of current additions to qualified pension plans and individual retirement accounts (IRAs) has encouraged individuals to save. Pension funds have grown geometrically in the past several years, and every indication is that they will continue to do so in the near future. Historically, pension funds have not been invested heavily in real estate, but pension funds are increasingly being seen, in the eyes of mortgage bankers and other lenders, as a logical source of real estate finance because their liability structures are longer-term in nature, and more closely match mortgage maturities than the liability structures of most other investors. For pension funds, the high yields and increasing marketability of mortgages should make attractive investments. MBA urges that individual long-term saving continue to be encouraged by the tax treatment of retirement funds.

### CAPITAL FOR REAL ESTATE

Several technical provisions are directed to those business organizations that devote capital to real estate. Depository institutions are allowed to allocate income to a bad debt reserve without paying tax on the allocated income. We note that mortgage bankers are not currently allowed this bad debt reserve treatment. Historically, mortgage bankers sold the mortgages that they originated to long-term investors, and so did not bear a risk of loss if the debt went bad. However, recently, mortgage bankers have become issuers of securities backed by mortgages, and, as such, have begun to realize losses when mortgages are not paid. MBA suggests that the allowance of a bad debt reserve for mortgage bankers should be considered by the Committee.

In addition to bad debt reserves for depository institutions making real estate financing available, Congress allowed the establishment of a special set of accumulators of capital for real estate, the real estate investment trusts (REIT). REITs survived the economic challenge of the mid-seventies and have proven successful as entities encouraging capital formation. Current law does not allow the REITs to retain income and manage a reinvestment program, which leaves them unattractive vehicles for certain types of investors. Reducing the percentage of income the REITs must distribute on a current year basis would further encourage their ability to attract capital. MBA urges the Committee to recommend that REITs, andother entities issuing mortgage-backed securities, be allowed to retain and manage a larger portion of their annual income.

MBA appreciates the opportunity to testify. We would be happy to answer any questions you may have.

## STATEMENT OF SCOTT SLESINGER, EXECUTIVE VICE PRESIDENT, NATIONAL APARTMENT ASSOCIATION, WASHINGTON, D.C.

Mr. SLESINGER. Thank you, Mr. Chairman, and members of the committee.

My name is Scott Slesinger. I am executive vice president of the National Apartment Association, a trade association representing 45,000 owners, developers, and managers of multifamily housing throughout the country.

Unlike commercial property, residential real estate rental is not subject to the normal economic rules of price, cost, and supply. In the commercial market, when supply and demand are in equilibrium and costs go up, so do rents. Any cost increases are then passed on to the buyers of the goods and services of the renter.

Rents, however, in the residential market are determined by what the renters can afford. Prices cannot go up as high as costs because, if they did, the renters who could afford these increases would find it to their economic advantage to become homeowners. Other tenants would then be forced to find other affordable accommodations, usually overcrowded or substandard housing. Therefore, without significant tax breaks for investors in rental housing, this needed commodity will not be provided. That is why we receive and need additional tax advantages such as the liberalized recapture and the accelerated depreciation so we can attract the needed capital.

A significant positive change caused by ERTA in 1981 has been the additional number of sales of rental buildings. These sales that have come under attack by some people in Treasury are critical for rental upkeep and rehabilitation. Since rents usually do not provide investors with sufficient cashflows to pay for major repairs, refinancing and sales have been the major ways to get the needed financing into projects. Before ERTA, lenders and investors had determined that low- and moderate-income projects did not have sufficient income to pay for required operation and long-term maintenance of our older housing stock unless it was located in an area where conversion was possible. This made the rental stock severely illiquid and made financing of needed repairs very difficult. Now the recapture rules, in tandem with the accelerated schedules for existing housing, have encouraged sales to take place. When properties are sold, the new investors have sufficient capital to make needed improvements in the property, something the former owners could not afford to do based on the existing rent levels.

Because of this tax treatment of residential real property, we estimate that a number of abandoned and lost units will dramatically decrease this decade. For the first time, the Federal Government is effectively encouraging the use of our Nation's existing rental housing stock.

Any changes in the tax treatment of existing structures would be most wasteful. Rehabilitation allows us to take advantage of our existing neighborhoods and schools, utilities, and other established infrastructure. Any change that would encourage a greater disposable society would be much more costly than the narrow and fairly small tax expenditure eyed by this committee.

Thank you. I will be glad to answer any questions.

The CHAIRMAN. Thank you, Mr. Slesinger.

[The prepared statement of Scott L. Slesinger follows:]

### STATEMENT OF SCOTT L. SLESINGER, EXECUTIVE VICE PRESIDENT, NATIONAL APARTMENT ASSOCIATION

Mr. Chairman and Members of the Finance Committee. My name is Scott Slesinger. I am Executive Vice President of the National Apartment Association, a trade association representing 45,000 members and over 2 million multifamily units. I appreciate the opportunity to speak before this Committee on what is a crucial issue to our industry, the tax treatment of residential real estate investment.

Most industrial and developing countries of the world have found that the only way to provide housing for the majority of their population is to build government housing. The major exception is the United States. In this country, we have all but left the housing problem to private enterprise and the tax treatment of residential housing.

Since the United States has taken this approach to housing, we believe that there is a need to have tax incentives such as accelerated depreciation and modified recapture if private investors are to continue to invest in rental housing. Today, nonleveraged multifamily housing investment, assuming only a 5% vacancy rate, would have the same rate of return as a U.S. Treasury Certificate. If investors and lenders are not sufficiently compensated for the substantial risks inherent in multifamily housing, private investment in rental housing will disappear. Investors and lenders want a competitive return with other investments. We believe the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Equality and Fiscal Responsibility Act of 1982 (TEFRA), have left a fairly level playing field for investors.

While rental housing does receive certain tax benefits, the indirect risks of multifamily investments require the marketplace to pay an incentive to lenders and investors. These fairly unique "risks" of rental housing include political interference with the rights of ownership such as rent control, increased difficulties in evicting tenants, local taxation of properties at commercial instead of residential rates, and laws inhibiting condominium conversion.

A short review of the recent historical problems of rental housing will highlight the need for and likely success of the 1981 Economic Recovery Tax Act.

Rental housing did not benefit from the real estate boom of the 70's. In fact, the industry was a victim of the inflation of that period. Only today is rental housing beginning to come out of the recession—of 1974. There are several reasons why the multifamily housing industry did not keep pace with other segments of the economy during this time.

One reason was that the inflation of the seventies forced many middle income families into higher tax brackets. This bracket creep forced the most economically secure renters to opt for homeownership in order to take advantage of the tax breaks given homeowners and the inflation protection afforded by the appreciation of ownership housing. This abandonment of rental housing by the middle class left a poorer rental class, one whose incomes failed to rise with inflation. Whereas median income increased 491 percent for all families from 1950–1979, renters' incomes increased only 257 percent. For the same period rents increased only 200 percent.

At the same time that inflation and the tax laws were making homeownership more attractive, tax law changes in 1969 and 1976 were adversely affecting rental housing investment. According to the HUD study, "Tax Incentives for Rental Housing", rents would have had to increase 9.9 percent to offset the reduction in benefits of those changes.

Despite the short supply of rental housing, rental housing owners were unable to raise rents at a pace matching the inflation of this period, particularly rising utility costs. For every year from 1972 until the dramatic drop in inflation last year, rents failed to increase as much as the CPI.

This drop in rental value and reluctance of lending institutions to invest in increasingly speculative rental housing, had a disastrous impact on many cities. The House Committee on Government Operations report entitled "Lowering the Cost of Rental Housing" gave examples of the phenomonen of illiquidity. Because resales or refinancing were difficult in many areas and rents and tax write-offs failed to leave adequate cash flow for operating expenses owners had to forgo repairs. This led to deterioration and in some cases, abandonment. Only buildings which were suitable for conversion were kept in usable condition.

Unlike commercial property, residential real estate rental is not subject to the normal economic rules of price, costs and supply. Commercial properties set rents based on supply, demand and costs. In the commercial market, when supply and demand are in equilibrium when costs go up, so do rents. Any cost increases are then passed on to the buyers of the goods and services of the renter.

Rents, however, in the residential market are determined by what the renters can afford. Prices can not go up as high as costs because if they did, the renters who could afford these increases would find it to their economic advantage to become home owners. Other tenants would then be forced to find other affordable accommodations, usually overcrowded or substandard housing. Rents are depressed by the income of the avialable market. Today, the renter population earns on average only 55 percent as much as the homeowning family. Therefore, without significant tax breaks for investors in rental housing, this needed commodity will not be provided. In fact, one major problem is that with all the tax breaks that exist, close to 25 percent of the families cannot afford decent housing without additional government assistance.

Homeownership is, in a way, in competition with rental housing. The tax advantage of homeownership must be paralleled by equal advantages for renters or investors in rental housing. We do not oppose the clear federal policy of encouraging homeownership. However, when the government formulates its taxing or spending policies, it must remember the less economically fortunate who are not able to take advantage of interest and real estate tax deductions, capital gains deferral on sale, or even single family mortgage bonds. These individuals must rely on rental housing.

Why do people invest in rental housing today? Most investment services discouraged such investments a few years ago. Today, however, investment activity has resumed. Clearly ERTA and lower inflation rates are major reasons. High income investors invest in rental housing for a combination of tax incentives. These incentives are: accelerated depreciation; modified recapture; and non-recourse financing. Those projects that receive investor capital are those likely to show a positive cash flow after three or four years. Interestingly, a major selling point in syndications is the possibility of a capital gain on the sale of the property after several years. There is the hope that sometime in the investment's life, perhaps 5 to 7 years down the road, a particular rental buidling will be sold . . . not to another rental investor, but for conversion to individual home ownership units . . . for a premium which the marketplace has estimated will increase the building's worth by 25 percent or more.

The tax changes in ERTA—the ending of component depreciation and standardization of the 15-year accelerated schedule for new and used property, has had a net positive impact on multi-family housing rehabilitation and construction. Today, however, the impact has been muted by the high interest rates during the past two years. As interest rates decline, we are beginning to see a number of significant and positive reactions to the 1981 Act.

A major reaction to ERTA is an increase in the rehabilitation of existing properties. This is because the 1981 Act made transfers of long-held rental property a more favorable investment. We believe this increase in rehabilitation is one of the great unexpected benefits of the 1981 Act. Since rents usually do not provide investors with sufficient cash flow to pay for major repairs, refinancing and sales have been the major way to get needed financing into projects. The recapture rules, in tandem with accelerated 15-year depreciation for existing housing, have allowed sales to take place. New investors have been able to pour needed money into projects to maintain their value for resale or for conversion. When properties are sold, the new investors have sufficient capital to make needed improvements in the property, something the former owner could not afford to do based on the existing rent levels. Because of the tax treatment of residential real property, we estimate that the number of abandoned and lost units will dramatically decrease this decade. For the first time, the Federal Government is effectively encouraging the use of the nation's existing rental housing stock—and on a scale that would not be possible through the appropriations process.

The impact that the 1981 Act will have on our cities has been gravely underestimated. A recent HUD study, "The Federal Tax Incentives and Rental Housing" merely mentions in passing the possibility that ERTA might encourage the upkeep and rehabilitation of the existing housing stock. We are finding that this possibility is becoming a reality.

Any changes in the tax treatment of existing structures, whether cutbacks in recapture or lengthening the life of rental property, would be most wasteful. Rehabilitation alows us to take advantage of existing neighborhoods and schools, utilities, roads and other established infrastructure. Any change that would affect this tax treatment, that would encourage a greater disposable society and would be much more costly than the narrow—and fairly small tax expenditure eyed by this Committee.

In certain parts of the country, rental housing construction is on the increase. However, we must underline that the reason for the upsurge in construction is the availability of tax-exempt financing. In other words, the 15-year life has not been so generous that it encouraged construction during the years of this last recession. In fact, the growth in new private residential rental starts is merely matching the upturn of the economy as a whole. Interest rates must still come down further if conventional financing for new rental housing will be practicable outside a few select markets in the Sunbelt.

A real estate investment, unlike most other types of investments taken by individuals is a long-term one. Most syndications are songularly illiquid—an investor is in for the long haul. The six month-one year issue for long term capital gains treatment means nothing to us. However, because real estate is long term, the importance of a stable tax policy is crucial. The major impacts of 1981 are now just taking hold. We urge this Committee to retain the present tax treatment of real estate, especially residential real estate, in order to give the 1981 Act a chance to work in the economy. We believe such action could have a major positive impact toward the nation's goal of decent, sanitary and affordable housing.

This Committee, in its difficult and probably thankless search for more revenues must remember its dramatic impact on the third of the population that rent. Thank you for giving me the opportunity to present the views of the National Apartment Association to this Committee. I would be pleased to answer any questions you may have.

## STATEMENT OF STEPHEN B. SMITH, MEMBER, EXECUTIVE COMMITTEE, COALITION FOR LOW- AND MODERATE-INCOME HOUSING, WASHINGTON, D.C.

Mr. Smith. Mr. Chairman, my name is Stephen Smith. I am president of The Investment Group, a Washington, D.C., based development and real estate syndication firm specializing, among other things, in low- and moderate-income multifamily housing. I am here today representing the Coalition for Low- and Moderate-Income Housing and the National Leased Housing Association. I am accompanied today by counsel for both of those organizations, Bruce Lane, with the Washington law firm of Lane & Edson, P.C.

Let me try to summarize my statement very briefly to leave as much time as possible for questions, but I would appreciate my full statements as well as the exhibits thereto being entered into the record.

The Chairman. Without objection that will be done.

Mr. SMITH. First of all, despite the reduction over the past several years in direct subsidies to low- and moderate-income housing, primarily the section 8 housing program, the need for such housing in this country has not abated. There still is a serious shortage of housing affordable by low- and moderate-income people in this country.

Second, the indirect subsidies provided through the Tax Code are the only real subsidies left to produce and maintain low- and moderate-income housing in this country. There are simply no other subsidy dollars available.

The 1981 Tax Act, by increasing tax benefits for various types of real estate, and in particular eliminating the distinction between new and existing properties, made it possible, really for the first time, to deal with some of the problems of existing low- and moderate-income housing projects—problems such as deferred maintenance, repairs, et cetera. We feel strongly that these tax incentives, with respect to existing properties, existing low- and moderate-income housing properties, should be maintained. It is simply the only way today to provide additional investment capital to those properties which need it. There are no other subsidies available.

Let me also invite your attention to a recent HUD study published in December 1982, entitled "Federal Tax Incentives in Rental Housing," which reached two very significant conclusions:

First, the shorter depreciation period contained in the 1981 Tax Act could result in a longer economic life for rental housing, which obviously is going to increase over the long run the supply of rental housing.

Second, because of the efficiency of the rental housing market, the increased tax advantages flow through to the tenants in terms of decreased rents.

Finally, I would like to invite your attention to another analysis that was made by a member of our coalition, Mr. David Smith, with the Boston Financial Technology Group, which concludes that the sale and syndication of existing low- and moderate-income housing projects made possible by the favorable tax provisions of the 1981 act result in very little if any net reduction in Federal tax revenues.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared statement of Stephen B. Smith follows:]

### STATEMENT OF STEPHEN B. SMITH, ON BEHALF OF THE COALITION FOR LOW- AND MODERATE-INCOME HOUSING AND THE NATIONAL LEASED HOUSING ASSOCIATION

Mr. Chairman and members of the Committee: My name is Stephen B. Smith. I am President of The Investment Group, a company located in Washington, D.C. We act as developers and syndicators of all types of government assisted low and moderate income housing. I am appearing here today in my capacities as a member of the Executive Committee of the Coalition for Low and Moderate Income Housing and as a Director of the National Leased Housing Association. I am accompanied by counsel for both organizations, Mr. Bruce S. Lane of Lane and Edson, P.C., Washington, D.C.

The Coalition for Low and Moderate Income Housing brings together in a single coalition all associations, trade groups, business organizations, and individuals, as well as associated professionals, involved in the private financing, production, rehabilitation and operation of government assisted low and moderate income multifamily rental housing. The Coalition works with the Administration, Congress, state governments and others in an effort to promote the financing, production, rehabilitation and operation through private enterprise of low and moderate income housing in the most effective ways possible. It is constantly seeking new and better methods for accomplishing that objective.

The National Leased Housing Association is an organization of approximately 800 members, which represents almost all aspects of the industry associated with the development, construction, ownership and operation of low and moderate income multi-family rental housing subsidized through the various federal housing programs. It consists of builders, developers, management companies, syndicators, public housing authorities, state housing finance agencies, non-profit organizations investment banking firms, architects, lawyers, accountants, and virtually every other profession, occupation and organization involved in this area of business.

Together, the two organziations encompass virtually this entire field of endeavor, and thus can speak about it with a considerable amoung of confidence and authority.

My remarks will be brief. It is my understanding that the purpose of the Committee's inquiry today is to consider the efficacy of the various tax expenditures that relate to real estate in order to determine whether they should be continued, modified, or abolished.

As you know, there has been a great shortage of multi-family rental housing for families and individuals of low and moderate income for many years, and that shortage continues unabated today.

Since the enactment of the Housing and Urban Development Act of 1968, Congress has attempted to subsidize the production and operation of such housing in a variety of ways, but all of the subsidies have taken two basic courses: direct subsidies, such as the Section 236 mortgage interest subsidy, and, more recently, the Section 8 rental subsidy program; and indirect subsidies, primarily through incentives contained in the federal income tax law. The tax incentives consist principally of the following: immediate deduction of construction period interest and taxes under Section 189; Accelerated Cost Recovery—essentially the 200 percent declining balance method over a 15 year period; and favorable recapture provisions upon ultimate sale or other disposition of the property. In addition, tax incentives have been directed at the rehabilitation of existing housing for multi-family rental purposes, principally Section 167(k) of the Code, which allows a 5-year write-off of rehabilitation expenditures up to $20,000 per dwelling unit, and the 25 percent tax credit provided for the substantial rehabilitation of historic properties for residential rental purposes.

During the past two years substantially all of the direct subsidies have been phased out by the Administration and by Congress. The Section 8 housing program, which at one time was responsible for the production of many thousands of new dwelling units per year, is no more, and most other direct subsidy programs fostering new construction have been drastically reduced or eliminated as part of the budget cuts. Accordingly, the only meaningful subsidies remaining are those provided through the Internal Revenue Code.

Fortunately, in 1981, at approximately the same time that direct subsidies began to be phased out, Congress was enhancing the tax incentives, principally through adoption of the Accelerated Cost Recovery System and the extension of that system to existing as well as new construction. In doing so, Congress recognized the special needs of low income housing and provided it with a slightly more favorable acceleration rate (200 percent DDB) than that provided for other real property (175 percent DDB). Were it not for these actions on the part of Congress, it is highly unlikely that there would be any production of low and moderate income housing today, and the existing housing stock would be deteriorating rather than being improved and recycled. Indeed, it is the recycling of existing housing stock which has done the most lately to deal with the nation's housing needs, both low income and conventional. The conversion to housing of buildings originally built for another use, such as warehouses, hospitals and office buildings, and the renovation of existing apartment buildings are creating much of the housing stock of this country today, particularly in the older states and cities.

Mr. Chairman, my point is a simple one: federal government has basically ceased the direct subsidy of new construction of low and moderate income housing, and it is reducing its direct subsidies of existing rental housing. Almost no replacement of these subsidies is being provided by the states or localities. without the incentives provided by the tax laws we would not be able to maintain the quality of our existing low and moderate income housing or create any such new housing.

At this point, Mr. Chairman, I would like to invite your attention to a study completed just recently, in December, 1982, by the Office of Economic Affairs of the

House of Policy Development and Research of the Department of Housing and Urban Development. A copy is attached as Exhibit B to this statement, and I ask your consent to publish this study in full as an exhibit to my testimony. It is entitled "Federal Tax Incentives and Rental Housing." This HUD study reaches two very significant conclusions:

*First, it concludes that the changes made by the tax law in 1981*, which extend tax benefits equally to existing and new housing, could "result in a reduction of economic depreciation and longer economic life for existing rental housing units. Longer economic life may result in decreases in housing abandonment and demolition and retention of more older units in the inventory." (p. iii).

Secondly, it concludes that "most of the benefits of rental specific tax provisions accrue to rents. Owners of rental property may benefit by themselves in the short run from a favorable change in rental tax provisions. However, an enhanced rate of return will attract more investment and lead to lower rents than would be obtained in the absence of the favorable change." (p.v.)

HUD's conclusions are further explained by the following excerpt from its study (p. 67):

"Tax incentives provide benefits to owners and investors of rental housing that serve to reduce the after-tax costs of providing housing services. Such after-tax cost reductions, in turn, increase the rate of return on rental housing investment. Increased rates of return attract capital to rental housing since investment funds in general tend to flow to equalize real after-tax, risk adjusted rates of return. An increased flow of investment capital into the rental market leads to an increase in quantity of housing services. This happens in many ways, such as increases in the qualify of existing units, new construction or conversion from other land uses. As a result, rents fall as owners attempt to attract prospective tenants."

Despite the beneficial effects which HUD has concluded have been conferred on new owners of existing low income rental housing by the 1981 Tax Act, it is sometimes argued that these tax incentives result in a loss of federal revenues. However, a recent analysis indicates that reyndication of existing apartment buildings to take advantage of the depreciation provisions of the 1981 Tax Act will have little or no impact on federal tax revenues. Rather than labor the point, I have attached to my statement as Exhibit A a copy of an article published on June 6, 1983, by BNA's Housing and Development Reporter which summarizes that analysis, prepared by David A. Smith of Boston Financial Technology Group, Inc., and I ask that that article be included as part of my testimony.

In summary, Mr. Chairman, the coalition for Low and Moderate Income and the National Leased Housing Association believe that the present tax incentives directed at the production, maintenance and rehabilitation of multi-family rental housing for families of low and moderate income are vital to that process and, indeed, are the only such incentives left, now that most direct subsidies have been eliminated. Moreoever, we agree with HUD that these tax incentives not only do the job, but, in the long run, the economic benefits of them accrue to the renters, and, as Mr. David Smith has demonstrated, at little or no cost to the Treasury. Accordingly, we believe that these tax incentives, as enhanced in 1981, should be left alone by Congress. Indeed, there are some clarifications and modifications to the code which, by separate letter, we will be happy to suggest to the Committee, and which, if enacted, would better effectuate Congress' intent in this area.

EXHIBIT A

HOUSING & DEVELOPMENT REPORTER

Volume 11, Number 2 THE BUREAU OF NATIONAL AFFAIRS, INC. June 6, 1983

## BUSINESS AND FINANCE

### ANALYSIS SHOWS RESYNDICATIONS WILL HAVE LITTLE IMPACT ON FEDERAL REVENUES

The resyndication of existing apartment buildings to take advantage of the depreciation provisions of the 1981 tax act will have little or no impact on federal tax revenues, according to an analysis by a Boston-based syndicator.

The analysis by David A. Smith of Boston Financial Technology Group, Inc. shows that here will be virtually no additional net tax expenditure for a resyndication without secondary financing. Even with secondary financing, the study says, the cost to the federal government will be relatively low, compared with alternatives to resyndication. In addition, Smith says, resyndication provides capital to upgrade projects and generally brings improved management.

The model used by Smith in his analysis is a 200-unit Section 236 project which went to final endorsement in 1972, with an original cost (debt plus equity) of $17,500 per unit, and which was resyndicated in January 1984 for values ranging from $16,250 to $25,000 per unit. Smith used a federal discount rate of 13 percent in his calculations. He also included certain mortality assumptions on the rate at which original partners would die, resulting in a step-up in basis and forgiveness of gain if the project weren't resyndicated.

#### Calculating Costs

In computing the net cost to the government of a resyndication, Smith notes, the tax deductions available to the new investors must be offset by the future deductions available to the original owners, in the absence of resyndication, and by the taxes paid by the original owners on the sales proceeds. (Technically, as Smith points out, the amount used in the calculation for taxes is the increased present value of taxes paid now over taxes that would be paid on the eventual sale of the project, if it weren't resyndicated.)

Smith uses three scenarios: a decline in project value to $16,250 per unit at the time of resyndication, with no secondary financing; an increase in value to $22,500, with some secondary financing; and an increase to $25,000, with a larger amount of secondary financing.

Under the first scenario, the analysis shows a net present value of the federal tax expenditure associated with the resyndication of $214 per unit, or 3 percent of the $1.285 million in capital raised through the resyndication. In this case, the taxes paid by the seller offset virtually all of the additional deductions available to the buyers. In the second scenario, the net tax expenditure is $2,068 per unit, or 32 percent of the capital raised, and in the third, the tax expenditure is $2,804 or 44 percent of capital raised.

Even the higher amounts, the report says, are less than one year's Section 8 contract and about half the cost of a mortgage assignment. Therefore, it says, if HUD might have to provide Section 8 assistance to a project or take an assignment, the government would be better off financially with a resyndication.

The CHAIRMAN. Senator Long.

Senator LONG. No questions.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. None, thank you.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. No questions.

The CHAIRMAN. First I would like to indicate that we have been working for some time in this area, trying to figure out some way to do a better job and a more efficient job than mortgage subsidy bonds without trying to restrict the use or issuance of mortgage subsidy bonds.

I have been working with staff and the joint committee and others on some new approach. And we are about prepared. I have been discussing it with various members on both sides of the committee, and we believe we have an idea that would save between 20- and 40-percent of the cost associated with mortgage bonds and also make certain that we are providing assistance to low- and moderate-income housing.

The bill would simply provide a new option for State and local governments and housing authorities that are now permitted to issue mortgage bonds. For any given year a State or locality could elect under this bill not to issue some or all of the mortgage bonds authorized that year by the Internal Revenue Code. In lieu of bonds, a State or locality would be permitted to issue mortgage credit certificates directly to home buyers. The mortgage credit certificate will enable the home buyer to buy down prevailing mortgage market interest rates by claiming a tax credit equal to a specified percentage of the interest paid on a home mortgage.

A tax credit program could be designed and implemented on the State and local level to do virtually everything that is currently feasible with mortgage subsidy bonds; however, because the tax credit mechanism is much more efficient than tax-exempt bonds, this bill can permit a 20-percent increase in the total amount of subsidy going to home buyers and still provide a savings of between 20 and 40 percent to the Federal Government. It is something I hoped you might take a look at. It has not yet been introduced, but we are looking for comments. It may not be the perfect answer, but it addresses a concern that has been expressed here this morning.

I think what I may do in the interest of time is to submit the questions, because there maybe some additional questions that affect probably each member of the panel, if that is satisfactory— So if I may do that, I will submit questions to each of the three witnesses, and perhaps within a week after that maybe we could have some response.

Mr. SMITH. Very good, Mr. Chairman.

The CHAIRMAN. Then I hope you might take a look at this idea that we have at least been focusing on now, and I will have the staff make available more complete information on that before you leave.

Thank you very much.

Mr. SMITH. Thank you.

The CHAIRMAN. Our next panel will be: Paul Huard, vice president, Taxation and Fiscal Policy Department, NAM; Charley Walker, chairman, American Council for Capital Formation; David Franasiak, manager, Tax Policy Center, U.S. Chamber of Commerce; and Norman Ture, chairman of the board, Institute for Research on the Economics of Taxation.

You may proceed in any order you wish, but I assume it will be in the order your names were called.

## STATEMENT OF PAUL R. HUARD, VICE PRESIDENT, TAXATION AND FISCAL POLICY DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS, WASHINGTON, D.C.

Mr. HUARD. Thank you, Mr. Chairman.

My name is Paul Huard. I am vice president for taxation and fiscal policy of the National Association of Manufacturers. I am pleased to be here this morning to present the association's views on the subject of tax expenditures.

NAM views the entire concept of tax expenditures with considerable skepticism. I will summarize the arguments against the tax expenditure concept which are set forth in detail in our written statement.

There is considerable dispute over what properly may be characterized as a "tax expenditure." This is because tax expenditures are defined, in effect, as "deviations from a normal tax structure," and there is no widely accepted agreement as to what such a structure is. Attempts to define a normal tax structure quickly become bogged down in both theoretical and practical objections, with the inevitable outcome being that arbitrary and subjective political decisions must be made in order to determine what is normal. Tax expenditures, as a result, exist primarily in the eye of the beholder.

A clear illustration of this point is that the joint committee's listing of tax expenditures contains some 17 items not listed as tax expenditures by the administration in Special Analysis G of the President's budget.

Further illustrating the previous point is the fact that certain items currently classified as tax expenditures such as ACRS, the investment tax credit, and various R&D tax incentives constitute to a greater or lesser degree a component of the tax laws of nearly every major industrialized country, raising the inference that such provisions would be more properly considered as being normal rather than as deviations. Typically, such provisions serve important economic purposes, and their dimunition or repeal would be seriously damaging to our domestic economy and to our ability to compete in worldwide markets.

Certain so-called tax expenditures items such as the preferential treatment of private pension plans involve public policy and planning decisions of a long-term nature, in this case, extending well into the next century, and are too important to be subjected to the vagaries of the annual congressional budgeting process.

The social security system involves the same type of long-term actuarial, demographic, and funding issues as the private retirement system, and I doubt that there would be much sentiment in the Congress with annual tinkering with the social security system in the name of deficit reduction. We would suggest the same rationale applies to the private retirement system.

Similarly, important capital formation incentives such as the accelerated cost recovery system were intended both to replace an inferior and outmoded depreciation system and to provide business planners with the certainty necessary to make informed decisions regarding future conduct. Subjecting such provisions to an annual review and adjustment would be totally destructive to the capital investment planning process.

Finally, in our view, allegations that tax expenditures are inequitably distributed are not well-founded. In reality, the distribution of benefits provided by tax expenditures is fairly wide and, viewed in the proper perspective, tends to often favor lower income rather than upper income taxpayers.

For all of the foregoing reasons, NAM recommends against the use of the tax expenditure concept as a device for identifying revenue increases. While this concept may be a convenient tool for those seeking reforms congenial to their political views, it should not be permitted to masquerade as a logical and objective methodology for analysis of the Federal tax laws.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement follows:]

## STATEMENT OF PAUL R. HUARD, REGARDING TAX EXPENDITURES ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

I am Paul R. Huard, Vice President for Taxation and Fiscal Policy of the National Association of Manufacturers. On behalf of the Association's 13,000 member firms, who represent 85 percent of the nation's industrial output and 80 percent of its industrial workforce, I am pleased to be here to present NAM's position on the subject of tax expenditures.

### I. INTRODUCTION

The concept of tax expenditures is relatively recent. The Treasury first began utilizing the concept in the late 1960s, and it was formally written into the law as part of the Congressional Budget and Impoundment Control Act of 1974 (P.L. 93-344), which defines tax expenditures as: "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."

For purposes of this definition, the terms "special" and "preferential" mean something which deviates from a normal tax structure. However, the statute offers no definition of what would be considered "normal" in this regard.

The annual tax expenditure estimates compiled by the Joint Committee on Taxation include roughly 100 provisions covering sixteen major policy functions, clearly indicating that the concept of tax expenditures is being applied very broadly. Since the term has been used so all-inclusively, the estimated revenue losses associated with tax expenditures are quite large. Using the definitions of the Joint Committee on Taxation, tax expenditures stand at $295 billion for fiscal year 1983 and are projected to rise by 12 percent to 14 percent annually, to $490 billion (in current dollars) by fiscal year 1988. Because of the magnitude of the numbers involved, there have been periodic suggestions that the Federal government should adopt an annual tax expenditure budget, subject to the same procedures as the actual budget.

NAM opposes the adoption of a tax expenditure budget, and views the entire concept of tax expenditures with considerable skepticism. Our arguments against the tax expenditure concept are summarized below and set forth in detail in the balance of this statement:

There is considerable dispute over what properly may be characterized as a tax expenditure. This is because tax expenditures are defined, in effect, as deviations from a normal tax structure, and there is no widely accepted agreement as to what such a structure is. Attempts to define a normal tax structure quickly become bogged down in both theoretical and practical objections, with the inevitable outcome being that arbitrary and subjective political decisions must be made in order to determine what is normal. Tax expenditures, as a result, exist primarily in the eye of the beholder.

Illustrating the previous point is the fact that certain items currently classified as tax expenditures constitute a component of the tax laws of every major industrial country, raising the inference that such provisions would be more properly considered as being normal. Typically, such provisions serve important economic purposes and their diminution or repeal would be seriously damaging to our domestic economy and to our ability to compete in worldwide markets.

Certain so-called tax expenditure items, such as the preferential treatment of private pension plans, involve public policy and planning decisions of a long-term nature—in this case extending well into the next century—which are too important to be subjected to the vagaries of the annual Congressional budgeting process.

Similarly, important capital formation incentives such as the Accelerated Cost Recovery System were intended both to replace an inferior and outmoded depreciation system and to provide business planners with the certainty necessary to make informed decisions regarding future conduct. Subjecting such provisions to annual review and adjustment would be totally destructive to the capital investment planning process.

Allegations that tax expenditures are inequitably distributed are not well-founded. In reality, the distribution of benefits provided by tax expenditures is fairly wide and, in certain respects, favors lower income rather than upper income taxpayers.

Any revenue gains which might result from implementation of a formal tax expenditure budget are likely to be far smaller than the magnitudes suggested by the aggregate revenues associated with tax expenditures. Repeal of some provisions classified as tax expenditures would in fact probably have a negative feedback effect on revenue collections.

## II. DEFINITION OF TAX EXPENDITURES

Perhaps the greatest difficulty with the tax expenditure concept is the lack of any general agreement on the meaning of the term "tax expenditure." While the statutory definition previously quoted might at first blush seem reasonably clear, the use of the terms "special" and "preferential,"—as applied to credits, deductions, exemptions, exclusions and rates—presupposes the existence of an underlying "normal" tax structure. Under the tax expenditure concept, all "special" or "preferential" provisions are deviations from the "normal" tax structure and, as such, are viewed as being analogous to direct federal expenditures or—to use the more pejorative term—as subsidies.

The central flaw in the tax expenditure concept is the presupposition that there is such a thing as a "normal" tax structure which can be defined in terms of firm conceptual principles. This flaw is amply illustrated by some of the more glaring inconsistencies in the current listing of tax expenditures:

*Rate structure.*—Presumably some type of rate structure is part of a normal tax structure. One would expect, for example, that either a progressive or a flat rate would be treated as normative. In the case of progressive individual rates, the Joint Committee on Taxation does not list as a tax expenditure the revenue loss from failure to tax individual taxable income at rates less than the top marginal rate (for individuals) of 50 percent. On the other hand, the Joint Committee does show as a tax expenditure the revenue loss from taxing the first $100,000 of corporate taxable income at rates less than the top marginal rate (for corporations) of 46 percent.

The underlying principle would seem to be that progressive rates are normal when applied to individuals but abnormal for corporations. A defensible rationale for this disparate treatment is, however, elusive. It is difficult to see why a sole proprietorship or partnership is not seen as being subsidized by the application of a progressive rate structure whereas the identical business if incorporated is so viewed. It seems as good a guess as any to conclude that, whatever the Joint Committee's rationale for treating corporate rates below 46 percent as subsidies, it does not find it politic to carry logical consistency too far where individual taxpayers are concerned.[1]

---

[1] On this particular issue the Administration, which issues its own list of tax expenditures as Special Analysis G to the President's annual budget proposal, is consistent in that it treats neither individual nor corporate rate variations as giving rise to tax expenditures.

*Double taxation.*—Devices intended to avoid double taxation of the same income are in certain cases treated as part of the normal tax structure, e.g., the foreign tax credit. On the other hand, the most egregious and blatant example of double taxation is the treatment of corporate income paid out to shareholders, and yet the minimal attempt to soften this punitive treatment by excluding the first $100 of dividend income ($200 on a joint return) is classified as a tax expenditure. If anything, logic would suggest that the tax levied on dividends in excess of the annual exclusion be viewed as a negative tax expenditure, *i.e.,* a departure from the normative rule which increases rather than decreases the government's tax receipts.

Other examples of inconsistency abound. Indeed, there is not even agreement between branches of government on what constitutes a normal tax structure: the Joint Committee lists as tax expenditures some 17 items which the Administration does not include in its own tax expenditure list (Special Analysis G of the Budget). The areas of discrepancy include such fundamental issues as whether or not adequate capital recovery is part of the normal structure of business taxation. Unlike the Administration, the Joint Committee staff persists in showing a portion of accelerated depreciation on business property as a tax expenditure, even though it concedes that, due to inflation, even accelerated depreciation will not always provide taxpayers with deductions whose real value corresponds to the acquisition cost of the asset being depreciated.

All of this points to the conclusion that the definition of a normal tax structure—and hence of a tax expenditure—involve a myriad of subjective and arbitrary decisions, frequently of a political nature. Accordingly, any tax expenditure budget will tend more than anything else to reflect the particular biases and objectives of those who constructed such budget. While such a budget may be a convenient tool for those seeking various "reforms," it should not be permitted to masquerade as a logical and objective methodology for analyzing the federal tax laws.

## III. DISCUSSION OF SELECTED TAX EXPENDITURES

Certain provisions of the tax laws now categorized as tax expenditures, when judged on the basis of tax laws throughout the other industrialized countries, should be viewed as normal and desirable components of the tax structure. These provisions serve valuable economic purposes such as increasing capital formation or stimulating research and development, and in this respect tend to raise the long term growth rate of the economy. Moreover, repeal or diminution of these provisions, as might occur under a formal tax expenditure budget, would reduce capital formation and would place American industry at a serious competitive disadvantage in relation to corporations in other major industrial countries. While an overview of the full range of business-oriented tax expenditures is beyond the scope of this statement, representative examples include accelerated depreciation, the investment tax credit, and provisions for research and development.

*Accelerated Depreciation.*—Prior to the enactment of the Accelerated Cost Recovery System (ACRS), depreciation laws in the United States were substantially inferior to corresponding laws in other major industrial countries. Under the prior Asset Depreciation Range (ADR) system, capital equipment could only be depreciated over the "useful life" of an asset, typically a fairly long period. Furthermore, because depreciation was calculated on the basis of the original acquisition cost of the equipment rather than the current cost of replacement, real depreciation costs were seriously understated during the 1970s, resulting in an increase in effective corporate tax liabilities.

A comparison of the ACRS depreciation system with depreciation schedules in other industrial countries reveals that it was ony after the enactment of ACRS in 1981 that American corporations were given comparable depreciation allowances. In Canada, for instance, 61.7 percent of the cost of a capital asset is recoverable in the first taxable year, and 108 percent is recoverable by the second taxable year. These figures take into account the added effect of the Canadian investment tax credit; otherwise, 50 percent of an asset is depreciable in the first taxable year, and the remaining 50 percent in the second taxable year. The United Kingdom has automatic first year expensing of capital equipment, i.e., assets are completely written off in the first taxable year. In France, 31.3 percent of asset costs are written off in the first taxable year, 67.6 percent by the third year, and 94.6 percent by the seventh. In Italy, 25 percent of asset costs are written off in the first taxable year, 75 percent by the third and 100 percent by the seventh.

In Sweden, depreciation is at a 30 percent declining balance rate for the first three years, followed by a 20 percent straight line rate. For certain categories, a special 20 percent allowance is granted against local tax obligations. Under this system, 50 percent of assets are written off in the first year, 85.7 percent in the third year, and 120 percent by the seventh. Swedish corporations may also allocate up to 50 percent of pre-tax income to a reserve fund for future investment in capital assets; in this instance, full cost recovery is granted prior to the investment, and qualifying capital allocations are also eligible for the 20 percent special allowance.

The clear fact is that our depreciation system desperately needed the correction that was accomplished by the enactment of ACRS as part of the Economic Recovery Tax Act of 1981 (ERTA). However, with the passage of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), ACRS already has been substantially diluted. To illustrate why NAM opposes any further annual reviews and adjustments to ACRS, whether under the guise of a tax expenditure budget or otherwise, we offer the observations set forth below.

Under ERTA, Congress intended to simplify the depreciation or cost recovery provisions of the tax laws, to provide greater certainty for investment decisions and planning, and to establish new incentives not then present in the tax law for increased investment and economic growth. Prior to ERTA, the effective tax rates on new investment were 15 percent for equipment and 48 percent for buildings. After ERTA and the subsequent TEFRA changes, the effective tax rates are 9 percent for equipment and 37 percent for buildings. While the gap in effective rates for these alternative investments has been somewhat narrowed, the effective tax rate for structures is still substantially higher. This marked disincentive for new building construction has been noted by the Congressional Budget Office, by Martin Feldstein before he became Chairman of the Council of Economic Advisors, and by others who have examined this area critically.

The existing ACRS treatment for structures should be retained. Changing that treatment would exacerbate the still existing disincentives in the U.S. tax laws for structures and would lead to certain cancellation of some planned construction and deferral of construction starts on other projects. Large building projects require anywhere from two to four years from commencement of the planning process to beginning of construction. Some permit approvals required by federal, state or local governmental agencies may further extend this pre-construction period. Future planning requires that the ACRS system be a stable and predictable one rather than a system subject to constant revision as part of the annual Congressional budgeting process.

Changing ACRS as applied to structures, which is increasingly spoken of as desirable by some, would also have the following adverse effects:

It would adversely impact unemployment in the construction industry. Currently, unemployment in that industry is 22.1 percent. Reduction in that rate requires increased not decreased building construction.

It would have significant adverse impact on industries related to or dependent upon the construction industry, for example, consumer durables (such as appliances, furniture, and other household goods), and construction materials (such as steel, glass and concrete).

It would continue and confirm the investor uncertainty and the disruption of the investment planning process. Tax provisions relating to real estate have been significantly changed in each of the past two major tax bills, and major changes have been discussed virtually every year in the recent past. Investors are already reluctant to commit capital to such new construction due to uncertainty as to their tax position and concomitant rates of return. In fact, in some industries the combination of the TEFRA requirement to capitalize construction period interest and a possible extension of the recovery period for structures from 15 to 20 years would completely offset, and then some, the relative benefits in rate of return accomplished by the enactment of ACRS in the first place.

Finally, as a general proposition NAM believes that any further change in the ACRS system—whether for equipment or for structures—would significantly set back the current and hopeful economic recovery. Congrerss should give the intended incentives in this area—or more properly stated what is left of them after TEFRA—a chance to provide the basis for a sustained economic recovery.

*Investment Tax Credit.*—The investment tax credit (ITC) has been amended repeatedly since its original enactment in 1962. It was not until more than a decade later than the 10 percent ITC was made permanent, and in 1982 under TEFRA the depreciale basis of assets qualifying for the ITC was reduced by one-half the amount of the credit. While the ITC is also classed as a tax expenditure, comparale provisions exist in othr countries, and its use both here and abroad as an integral element of capital recovery systems militates against classifying it as abnormal.

In Canada, investment tax credits of 7 percent, 10 percent and 20 percent are granted for various classes of machinery and structures. In France, Businesses are allowed to deduct 10 percent of qualifying investments from taxable income. In Germany, a variety of investment tax incentive provisions are offered, including 12 percent to 20 percent tax reductions for certain types of investments, cash premiums of 10 percent to 40 percent on othr types of investment, and additional grants of up to 25 percent of investments in given regions. In Italy, a 50 percent reduction in corporate tax liabilities (from 25 percent to 12.5 percent) is granted for new incorporations in depressed regions. In Japan, an investment tax credit of 5.5 percent to 7 percent of the acquisition of energy saving capital equipment is allowed, although the amount of the credit is limited to 20 percent of the corporate tax.

*R&D Tax Provisions.*—Several current R&D tax provisions are listed as tax expenditures, including expensing of research expenditures, the incremental credit for research activities, and suspension of regulations relating to allocation under Section 861 of the Treasury Regulations of R&D outlays. However, other countries have comparable tax provisions, and up to the enactment of the Economic Recovery Tax Act of 1981, the only major R&D-related provision in the United States consisted of expensing of research costs, with the result that up to that time, American R&D provisions were substantially inferior to those in other countries.

In Canada, expenditures for research are deductible in the first year incurred. There is also a 50 percent tax credit for incremental research spending in excess of a three year base period amount. Contributions to scientific establishments are also tax deductible. In West Germany, R&D tax expenditures are deductible in the year in which they are incurred. Capital expenditures for research facilities are subject to accelerated depreciation. The acquisition cost for research conducted by other institutions is depreciable over the useful life of the asset. There is a 7.5 percent investment tax credit for capital expenditures used in research. In France, R&D expenditurers are deductible in the year in which they are incurred. Capital equipment used for research may be depreciated either through straight-line depreciation (which applies to all other categories of capital assets) or through declining balance methods. Buildings used for research are eligible for faster write-offs.

In sum, the listing of incentives for capital formation and R&D as tax expenditures is not commensurate with widely accepted practices throughout the industrial world. Every major industrial country has made extensive use of tax provisions designed to stimulate R&D. These provisions have by and large been successful, and have assisted in keeping industry throughout the advanced economies on a comparable competitive footing with its competitors. Curtailment of these provisions would therefore have the effect of placing domestic industry at a comparative disadvantage both in domestic and world markets.

Another so-called "tax expenditure" which is of vital concern to industry is the area of private pension plans. Sound national policy has been developed and fostered over the years to encourage the private sector to provide workers and their dependents with adequate retirement income. This has been done in many ways, including the deferral of taxes on contributions made to qualified retirement and profit sharing plans as well as on income earned by plan trusts. [At this point, however, it is important to stress that we are speaking here of tax deferral, not tax avoidance. Ultimately today's worker who is a participant in a pension plan will pay taxes on the benefits received at retirement.]

The crucial role of private pension plans in retirement income security cannot be disputed. The recent debate over Social Security demonstrates how vulnerable the Social Security system is to unanticipated fluctuations in economic conditions and social and demographic projections. Clearly, Social Security can be expected to play a diminishing role in total income replacement, particularly for those of the "baby boom" era who will begin retiring in the next century. It is private sector initiatives such as pension plans which will mean the difference between a retiree living reasonably well or living close to the minimum subsistence level.

Congress has long been committed to assuring the security of employee retirement income. This was the goal of the Employee Retirement Income Security Act of 1974 (ERISA) which, among other things, established funding requirements, fiduciary rules, minimum standards on vesting, and plan termination insurance. In the words of a principal co-sponsor of ERISA, Senator Jacob Javits, in testimony before the Senate Labor Subcommittee on May 24, 1983: "in my view, the Act was as important a piece of social legislation as the Social Security Act of the thirties." Senator Javits went on to observe that when ERISA was enacted in 1974, approximately 425,000 plans with an estimated $194.5 billion in assets were under ERISA's jurisdiction. These plans covered about 30 million workers and 7 million beneficiaries. In eight years, according to Senator Javits, the figures jumped to 745,000 plans with $C24 billion in assets covering 50 million workers and 10 million beneficiaries.

Clearly, the Congressional objective of extending coverage to many workers in tax qualified retirement programs is being accomplished.

Recently, however, under the pretext of a need to control so-called tax expenditures, ERISA changes have been made and are being proposed with little consideration as to their impact on the private pension system as a whole. NAM feels that the security of workers' pensions should not be left to the mercy of the annual budget process. Certainly, we do not think that Congress would ever resort, in the name of the budget process or the fight against deficits, to annual reviews and adjustments of the Social Security System. The private retirement system is a necessary and desirable complement to Social Security and likewise is entitled to stable long-term treatment that employers and employees alike can rely on.

Although we do not agree that revenue loss numbers are a particularly appropriate basis for establishing and reviewing long term pension policy, it seems inevitable that such numbers will be so used by some. It is therefore imperative that these calculations be made in the most forthright and accurate manner. In this regard, we note that the tax expenditure estimate for private pension plans has without explanation increased from $27.5 billion in the Administration's fiscal year 1983 budget document to $49.7 billion in the fiscal year 1984 budget document. This year-to-year upward variation of $22.2 billion is at least suggestive of a desire on someone's part to establish private pension as an attractive target for further "reform." If there is a different explanation, then it certainly should be given wider publicity than it has received to date.

Finally, if tax expenditure numbers are to be used as a basis for judging for any changes in pension policy, the underlying assumptions for making such calculations must be more thoroughly examined. Since, unlike many other items on the tax expenditure list, tax expenditures for private pensions really represent taxes deferred rather than taxes foregone, there should be some recognition given to the present value of the taxes that will be collected when currently accruing pension benefits are in pay statuts.

## IV. DISTRIBUTION OF TAX EXPENDITURES

One of the major arguments for curtailing or eliminating tax expenditures has to do with their allegedly inequitable distribution. According to one viewpoint, tax expenditures are excessively weighted toward upper income taxpayers, and accordingly reduce the progressivity of the tax system. The evidence on the distribution of tax expenditure benefits by income class, however, disputes this contention, and suggests that the distribution of tax expenditure benefits actually covers a wide range of income classes. Of course, the distribution of benefits by income class depends largely on the particular tax expenditure. The age exemption primarily benefits low and middle income taxpayers. The distribution of benefits resulting from such provisions as the mortgage interest deduction covers a broad range of income groups, due to the increase in owner-occupied housing among middle income taxpayers.

A review of the distribution of benefits by income bracket indicates the largest dollar amount of tax expenditure benefits goes to middle income taxpayers, while the second largest dollar amount goes to upper income taxpayers and the lowest dollar amount to the low income brackets. There are admittedly fewer taxpayers in the upper income categories, and it is primarily on the basis of per capita analysis that the distribution of tax expenditure benefits is alleged to be inequitable.

However, when the distribution of benefits is expressed as a percentage of the tax liabilities of each income bracket, a much different pattern appears. Tax expenditures attributable to the lower income brackets are a very high percentage (often close to or in excess of 100 percent) of the tax liability for that income bracket, whereas this percentage becomes much more modest as one moves upwards through the middle and upper income brackets. Thus, while it is true that the absolute dollar amount of tax expenditures is concentrated in the higher income brackets, this is merely reflective of the fact that such taxpayers pay the most of the taxes in the first place. But when tax expenditures by income bracket are viewed as a reduction of what that bracket's tax liability would have been without the tax expenditure, the largest percentage reductions in tax liability occur in the lower income brackets.

## V. TAX EXPENDITURE BUDGETS

A major argument against use of a tax expenditure budget is that the revenue figures associated with tax expenditures are not entirely realistic. These figures are only valid if the economy behaves a certain way. However, tax policies represent a major determinant of economic behavior. Therefore, if tax policies are changed, this may induce corresponding changes in the behavior of the economy, which in turn alter the revenue impact of the tax laws. To put it another way, the revenue figures associated with tax expenditures do not necessarily represent valid estimates of the revenue gains that would accrue in the event that given tax provisions were modified or repealed. Instead, it appears probable that elimination of certain provisions now classed as tax expenditures might have negative feedback on actual revenue, rather than result in revenue gains.

This seemingly paradoxical conclusion is explained by the fact that tax expenditures have frequently been designed to increase economic activity in certain sectors, and in this respect repeal of tax expenditures would lead either to decreases in economic activity or at best sectoral reallocations of resources. Thus the revenue effects associated with repeal of certain tax expenditures would probably be negative. Business-oriented tax expenditures such as lower rates on the first $100,000 of corporate income, investment tax credits and accelerated depreciation on capital expenditures all have the effect of generating greater corporate liquidity and profitability, as well as higher capital investment. Therefore, rescission of these provisions would effectively translate into decreases in rates of after tax profit and reduced investment spending. Indirectly, this would tend to lower real growth and employment, leading to a contraction in federal revenues.

On the individual side, provisions such as reduced tax rates on capital gains and deferral of capital gains taxes on certain kinds of transactions also have the effect of stimulating investment, and in this respect their repeal also would be counterproductive from the standpoint of raising additional revenue.

In other instances, changes in the current system of tax expenditures would lead to substantial sectoral reallocations in economic activity which would entail serious adjustment costs in the short term. For instance, repeal or modification of the deductibility of mortgage interest would in the short term lead to decreases in residential investment, fewer housing starts and higher unemployment in the construction industry. The long term effects would probably include lower interest rates due to slower growth but greater liquidity, increased consumer spending on non-durables and increased reliance on urban rental housing rather than suburban homes. It is unlikely that revenue gains from these long run effects would outweigh the short run revenue losses caused by dislocations in the housing industry.

The implication of these examples is that the main effect of major changes in tax expenditures could be changes in the sectoral distribution of economic activity, without necessarily raising more revenue. On these grounds also, the proposal of a tax expenditure budget would clearly be counterproductive.

### CONCLUSIONS

The entire concept of tax expenditures suffers from the inherent drawback of being poorly defined. The manner in which the concept has been applied during the past few years has been too all-encompassing with the result that it includes any number of components of the tax system that should not be classed as tax expenditures, i.e., which logically should not be treated as deviations from the normal tax structure. Instead, many items termed tax expenditures should be regarded as normal and integral components of the tax structure. Of the major business-oriented provisions classed as tax expenditures, most have historically had a beneficial economical impact. Moreover, these provisions (or comparable provisions) have been common to the tax codes of all the major industrial countries. Allegations that tax expenditures are inherently inequitable or are weighted excessively toward upper income brackets are difficult to substantiate. Finally, curtailment or rescission of major provisions of existing laws now categorized as tax expenditures would probably not enhance Federal revenue, but more likely would have a negative economic impact and therefore ultimately result in revenue losses.

For all of these reasons, NAM opposes the adoption of a tax expenditure budget.

## STATEMENT OF DR. CHARLS E. WALKER, CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION, WASHINGTON, D.C.

Dr. **Walker**. Thank you very much, Mr. Chairman.

My name is Charls Walker, I am chairman of the American Council for Capital Formation.

Mr. Chairman, I would like very much to share my views with the committee on what the congressional budget process has done to the tax writing timetable and procedures in the Congress, and on tax actions to meet the 1984 budget resolution. But given the shortness of time, I must confine my oral remarks to the tax expenditure discussion in my statement.

But on the former, let me simply say that these budget-driven sprints to enact big annual tax bills in very short periods of time are not fair to your committee, not fair to taxpayers, and not good for the economy. As the chairman has been reported to have said, you do indeed in this instance have a "dead cat" on your hands.

Turning to tax expenditures, my statement can be summarized as follows: First, the concept of corporate tax expenditures is a badly-flawed concept as a policy tool. Corporations do not pay taxes; they are only surrogate tax collectors for the Internal Revenue Service. Taxes levied on corporations are paid by individuals in their roles as consumers, workers, savers, and investors. This means that when you raise revenue by reducing a corporate tax expenditure, you really don't know who pays the tax. And this means you can't tell whether it enhances tax equity or not.

For example, avid tax reformers appear to believe that the ultimate in corporate tax equity would be a system under which all firms and industries were taxed at the same effective tax rate. But since corporations are only tax collectors, the ultimate impact of this uniformity might, for the individuals who are really hit, be very incquitable indeed.

This equity aspect is aside from the policy effect of changing tax expenditures—for example, the impact on capital formation. I therefore suggest that you move very carefully in legislating as to corporate tax expenditures. At the least, your staff should be required to produce some credible estimates of the ultimate impact of such changes on the people who reallv pay corporate taxes.

Second, Congress over the years has moved strongly toward exempting saving and investment income from taxation. For example, the investment tax credit, accelerated depreciation, the capital gains exclusion, Keogh's, IRA's, et cetera. Isn't it time to recognize what both the public and Congress seem to want, in the form of a tax system better suited to promote capital formation, by redefining the normal tax structure to exclude all saving and investment income? I submit that this step is fully within the authority of the tax-writing committees and could be accomplished in one fell swoop. This would help countercharges that capital formation provisions have been slipped into the law as a benefit for the rich. And if, as more and more tax experts and public officials are coming to believe, this nation must sooner or later move toward a broadbased consumption tax to help fund the Federal Government, this sensible redefinition of normal tax structure to exclude saving and investment income could advance the process of deliberation.

Thank you very much.

The CHAIRMAN. Thank you very much.

[The prepared statement follows:]

## STATEMENT OF DR. CHARLS E. WALKER, CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. Chairman and Members of the Committee, my name is Charls E. Walker. I am volunteer Chairman of the American Council for Capital Formation. I appreciate the opportunity to present the views of the American Council on the list of Federal tax expenditures constructed by the staff of the Joint Committee on Taxation.

The American Council for Capital Formation is an association of individuals, businesses, and associations united in their support of Federal policies to encourage the productive capital formation needed to sustain economic growth, reduce inflation, restore productivity gains, and create jobs for an expanding American work force.

Mr. Chairman, the Committee's hearings on the merits and demerits of the various "tax expenditures" are both timely and appropriate. Opinion is growing that any reasonable combination of economic growth and likely spending restraint may not be sufficient to bring the post-1985 Federal deficits down to tolerable levels; as a result, large tax increases may well be necessary in the period ahead. Far too often, members of the public and the press jump to the conclusion that a "tax expenditure" is by definition a "tax loophole" and, with the total ranging into the hundreds of billions or dollars, that a scaling back of "tax expenditures" is both the simplest and fairest method of reducing those outyear deficits. It is to be hoped that these hearings will help dispel that view.

In addition, these hearings can help assure that Members of Congress also fully comprehend all aspects of "tax expenditure" changes to raise revenues. The power to tax is indeed the power to destroy. That power should be wielded carefully, judiciously, and with ample time for all interested parties to make their cases and for legislators to understand fully just what the economic impacts of their votes are likely to be. These hearings are therefore most timely in setting the stage for the tax debate in the months ahead.

For any such discussion of "tax expenditures" to serve these important ends, several questions must be addressed. Recalling that upwards of two thirds of last year's Tax Equity and Responsibility Act hit business corporations, does the concept of "tax expenditures" for corporations, which do not ultimately bear taxes but pass them on to others, have the same validity as when applied to individuals? Are all entries on the "tax expenditure" list prepared by the Joint Committee staff valid entries; i.e., do they fully meet the criteria for tax expenditures as defined in the Budget Control and Impoundment Act of 1974? Do the public policy goals that justified the original enactment of important capital formation measures, such as the investment tax credit, accelerated depreciation, and the capital gains exclusion, still do so?

My testimony will consist of an attempt to answer these important questions, primarily from the standpoint of the capital formation needed to foster productivity and growth.

## CORPORATE TAX EXPENDITURES: A FAULTY CONCEPT

Seldom has a conference of tax experts been held in recent months without the corporate income tax coming in for strong indictment as to its appropriateness as a part of our tax system. Some experts attack double taxation of dividends, decrying its negative impact on capital formation as well as its unfairness. Some of the more theoretically oriented critics opine that the corporate tax is extremely distortive to investment decisions and therefore leads to inefficient allocation of economic resources. Still other more practical minded experts point to the simple and irrefutable fact that there is no way on earth that a corporation can be taxed; people can be taxed, but a corporation, which is simply a legal arrangement for conducting business, cannot. Since the tax it pays is either passed forward to consumers or backward to the factors of production, the corporation serves only as a surrogate tax collector for the Internal Revenue Service. To the extent the corporate tax is passed forward, it is doubtless regressive; this is because people with low incomes spend a larger portion of their income on the products of American business than do people with high incomes, who save more. To the extent the tax is passed backwards, to labor, take-home pay is lower than otherwise and jobs may be lost. To the extent the corporate tax is borne by the savers and investors who supply badly needed capital, their return on investment is cut and capital formation impeded.

An individual "tax expenditure" is, on the other hand, easy to identify with respect to primary impact. The interest and property tax deductions directly aid homebuyers. The medical deduction helps sick people. Charitable contributions, also a "tax expenditure," are important to taxpayers who support churches, charities and private schools. And so on.

In contrast, when a corporate "tax expenditure" is eliminated or reduced, the impact on individuals is impossible to identify precisely. The increase in the corporate tax payment is only a first order effect; thereafter, individuals as consumers, individuals as workers, and individuals as savers/investors are hit in varying degrees, depending on a variety of factors.

Why do legislators venture forth into such an uncharted area, enacting tax increases on business that may be regressive, or harmful to capital formation and jobs? The answer is, in part, political. Just as corporations don't pay taxes, people do; corporations don't vote, people do. It is no accident that in 1982, an election year, so much of the legislated tax increase hit directly at corporations, rather than individuals.

In addition, Congress, the press and the public appear to have implicitly accepted effective tax rates as the measure of "tax equity" in the corporate sector. It is "unfair," it is argued, for Corporation X to pay an effective tax rate of, say, only 5, 10, or 15 percent, whereas Corporation Y and many others pay effective rates that are much higher.

Effective corporate tax rates are unsatisfactory and misleading indicators of tax equity for two reasons. First, as already noted, the tax rate paid by the corporation tells us nothing about the relative share of the burden borne by the ultimate taxpayers—consumers, workers, savers and investors. For example, an increase in taxes on a public utility, where almost all costs are passed forward to consumers, will doubtless be regressive in impact. This would also be the case with respect to a tax increase on a low-margin, highly competitive retail business such as a grocery chain.

Last year, in the tax bill, much was made of alleged tax avoidance on the part of defense contractors. Reform of the so-called "completed contract" method of accounting would, it was argued, strike a blow for tax equity and reform by raising the effective tax rates paid by those companies. The relevant provisions of the Tax Code were indeed tightened. But, now much of the impact will fall on the defense contracting firms, and how much on the Pentagon?

Using effective tax rates as the criterion for tax equity among corporations can easily lead to bad tax policy because of the apparently simple approach of raising those rates through some type of minimum income tax for corporations. Not only does it make little sense to place a minimum tax on an institution that is not truly a taxpayer, but is in fact a tax collector; the minimum tax itself, if structured as in the past, can be especially damaging to certain companies and industries.

If any given corporation is paying a low effective tax rate, it is because it takes advantage of duly authorized credits, deductions, and exclusions. It is these provisions which should be examined as to their contribution to public policy.

This is, of course, what the Committee is doing in these hearings. But let me urge you to keep constantly in mind what seems to be very clear, namely, that the concept of corporate "tax expenditures" is seriously flawed as an analytical tool for tax policy. Changes in those tax provisions can have both short and long-term effects on individuals that no one can predict. In addition, if the corporate tax is, as more and more experts agree, a bad tax, then any steps to increase its impact either indirectly or directly, can be strongly questioned.

### VALID ENTRIES ON THE "TAX EXPENDITURE" LIST

The legislative history of the Budget Act indicates that "tax expenditures" are to be defined with reference to the "normal" tax structure. Given the importance of the public and press perception of "tax expenditures" as tax loopholes for rich individuals and corporations, definition of "normal" tax structure takes on overriding significance. Considerable disagreement exists among tax experts as to this definition, and that disagreement has carried over to the annual lists of "tax expenditures" prepared in Congress and in the Executive Branch. For example, the Joint Committee staff has noted seventeen differences between its list of March 7, 1983, and Special Analysis G of the President's 1984 Budget.

It is not my purpose today to discuss those specific differences, but instead to raise a more fundamental question relating to saving and investment "tax expenditures." That question is: Has not the time come for viewing the "normal" tax structure as one that excludes all saving and investment income both on the part of individuals and corporations? [1]

This idea is neither new nor radical. Classical economists did not consider income from saving and investment to be income in a fundamental sense, stressing instead the eminently sensible idea that income should be viewed in terms of consumption, with saving excluded. And the fact is that Congress has in recent years been moving very much in this direction. Since 1978, tax rates on capital gains have been cut from a peak of almost 50 percent to 20 percent today. The new Individual Retirement Accounts and more liberal Keogh provisions, vastly popular, permit individuals at least to defer some of the taxes on income that is saved. Beginning in 1985, taxpayers filing a joint return will be allowed to exclude net interest income up to $6,000 per year. In addition, the Economic Recovery Tax Act of 1981 (ERTA) provided for tax-free reinvestment of dividends paid by public utilities up to $1,500 per year on joint returns.

---

[1] I am using the term "saving and investment income" to refer both to income that is saved, rather than spent on consumption, and the subsequent income on the investment that saving makes possible.

On the corporate side, the most striking elements of Congress' concern with over taxation of saving and investment have involved capital cost recovery. The investment tax credit, first enacted at 7 percent in 1962 but twice suspended in the 1960's, is now a permanent 10 percent. With the passage of the accelerated cost recovery system (ACRS) provisions of the Economic Recovery Tax Act of 1981 (ERTA), Congress emphasized its desire to provide additional investment incentives. When the ITC was coupled with the 10–5–3 depreciation plan, business income devoted to the purchase of new capital assets was, to a considerable extent, exempt from Federal taxation. In 1982, in response to critics' charges that ERTA provided benefits which exceeded those of expensing, changes were made by ACRS which reduced ERTA's cost recovery benefits but left most firms as well off as they would be under expensing. That is to say, the "expensing" of capital investment that many economists now advocate as a boost to capital formation and productivity growth has in fact been approximated.

The case for exempting all individual saving and investment income from taxation and expensing of business capital investment is both simple and logical. It is based upon the view that in an economy whose health is so dependent on high and sustained levels of productive investment, it is foolish to tax saving and investment as heavily as we have in the past. In the case of an individual, over the years we have—in our "normal" tax structure—taxed income when received, even though saved, and in addition taxed income that flows from the saving in the form of interest, dividends or capital gains. At the corporate level, the income used to purchase capital assets has been taxed when earned, and the income generated by the investment has been taxed again as received.

Congress, in its wisdom and to its great credit, has been moving strongly away from this anti-investment posture. With the exception of the unfortunate aberration in TEFRA, which rescinded about half of the capital cost recovery benefits enacted in 1981, the trend has been steady and significant.

I submit that the goals of capital formation and productivity growth could be given a meaningful boost if the tax-writing committees of the Congress gave explicit recognition to the importance of those goals by shifting the definition of "normal" tax structure so as to exclude saving and investment income from taxable income. This would in effect reaffirm the classical view that such receipts are not income in fundamental sense. It would help counter charges that the special deductions, credits and exclusions for interest, dividends and capital gains are unjustified "tax expenditures" that have been slipped into the law as a benefit for the rich.

This step might well serve another important purpose. Even though economic growth may be strong and spending restraint firm, the additional tax revenues needed to bring down Federal deficits after 1985 may still be huge, in the $50 to $100 billion range. Many tax experts are beginning to doubt that revenues of this size can be raised through an income tax that is already in serious trouble. The American middle class, whose political clout is great and whose support is crucial to the viability of the tax system, is increasingly disenchanted with the income tax and, it is believed, increasingly attracted to the "underground economy." With indexing of individual income tax rates to begin in 1985, unlegislated tax increases will come to an end.

Consequently, there is growing support in the academic community and among tax policy experts and public officials for a shift toward some form of a broad-based consumption tax. Properly structured, such a tax could provide a politically viable and economically sturdy base for raising revenues to bring down deficits and adequately fund the Federal government in the decades ahead.

Needless to say, any such shift in the Federal tax system will require extensive and careful debate. But with a growing consensus in favor of consumption-based taxes, the Congressional tax committees could, almost by a stroke of the pen, advance the process of deliberation by tightening the definition of "normal" tax structure so as to exclude all saving and investment income.

### "TAX EXPENDITURES" AND CAPITAL FORMATION

I have implicitly answered the question of whether the public policy goals that originally justified the investment tax credit, accelerated depreciation, and the capital gains exclusion still do so. The better course of action would be to drop these items from any and all lists of "tax expenditures" by excluding saving and investment income from the definition of "normal" tax structure. Failing that, a ringing Congressional reaffirmation of these tax provisions as affording strong and vital support for capital formation is, it seems to me, every much in order. Following enactment of the Economic Recovery Tax Act in 1981, few could question the public and Congressional support for tax policies to promote productive investment. But when TEFRA rescinded almost one-half of the ACRS cuts granted in ERTA, strong doubts arose.

In the TEFRA legislative conference last summer, Senate representatives, with the support of the Administration, attempted to postpone rather than cancel those ACRS rescissions, but the House conferees refused to agree. With all "tax expenditures" under review by this Committee, now is a good time for reaffirming Congressional support for capital formation. Preferably this could be done by removing saving and investment income from the definition of the "normal" tax structure. Alternatively, it can be done by explicitly endorsing saving and investment "tax expenditures" as vital to this country's efforts, now well underway, to establish strong, lasting and non-inflationary economic growth.

## STATEMENT OF DAVID E. FRANASIAK, MANAGER, TAX POLICY CENTER, U.S. CHAMBER OF COMMERCE, WASHINGTON, D.C.

Mr. **Franasiak.** I am Dave Franasiak, manager of the Tax Policy Center of the U.S. Chamber of Commerce. I am accompanied today by Kenneth Simonson, senior tax economist. We welcome this chance to present the chamber's views on tax expenditures, a subject of importance to all of our 213,000 members.

The term "tax expenditures" has been used since the late 1960's, even though users did not agree on which parts of the Tax Code are tax expenditures.

The tax-writing committees have rightly ignored efforts to give special attention to tax expenditures at the expense of other parts of the code. Congress has rightly rejected all attempts to make tax expenditures automatically subject to budget or sunset mechanisms or to assign tax expenditures to others' committees.

The concept of tax expenditures assumes that the Government is entitled to everyone's income as long as the tax is part of the normal tax regime. We strongly reject this notion.

The chamber recommends that the Senate Finance Committee continue to review all parts of the Tax Code, particularly those provisions which affect the rates of savings and investment. Sole reliance on an arbitrary list of tax expenditures, on the other hand, will not provide a satisfactory framework for making proper tax policy choices.

The Tax Equity and Fiscal Responsibility Act of 1982 provides an all too clear illustration of this principle. That tax bill was promoted as a way of closing loopholes and tightening outdated preferences, but it removed over 70 percent of the tax reductions granted to business under the Economic Recovery Tax Act of 1981 and caused many businesses to cancel investment or pension plans.

We urge you not to raise taxes again this year in the name of trimming tax expenditures. Indeed, in a topsy-turvy world of tax expenditures, perception does not comport to reality.

For example, it is commonly assumed that ERTA led to an expansion of tax expenditures and that TEFRA tightened up on them. In fact, just the opposite is true. Joint committee data show that tax expenditures decreased in cost from 1981 to 1982 and increased from 1982 to 1983, following the passage of TEFRA.

Another myth is that Congress created most of these tax expenditures in the last several years. Not true. Seventy of the 104 items on the CBO list are at least 15 years old, and 9 of the 10 largest were enacted before 1943.

In conclusion, we urge that the committee avoid enacting a major tax increase this year. To do so would jeopardize the economic recovery now underway.

These hearings are important but should not provide the sole basis for committee action with regards to tax increases. We urge the committee to go beyond the incomplete and static data in the tax expenditures area and focus on tax policies which will stimulate investment, savings, economic growth, and, most importantly, job creation.

Thank you.

[The prepared statement of David E. Franasiak follows:]

## STATEMENT FOR THE CHAMBER OF COMMERCE OF THE UNITED STATES, BY DAVID E. FRANASIAK

I am David E. Franasiak, Manager of the Tax Policy Center of the U.S. Chamber of Commerce. I am accompanied by Kenneth D. Simonson, Senior Tax Economist. We welcome this chance to present the Chamber's views on "tax expenditures," a subject of importance to all of our 213,000 members.

### OVERVIEW

The concept of tax expenditures has a long but not a distinguished history. Although the term has been used since the late 1960s, users do not agree on which parts of the tax code are tax expenditures. the tax-writing committees have rightly ignored efforts to give special attention to tax expenditures at the expense of other parts of the code. Congress has rejected all attempts to make tax expenditures automatically subject to budget or "sunset" mechanisms, or to assign tax expenditures to other committees. The concept of tax expenditures assumes that the government is entitled to everyone's income, as long as the tax is part of the "normal" tax regime. We strongly reject this notion.

The Chamber recommends that the Finance Committee continue to review all parts of the tax code, particularly those provisions which affect the rates of savings and investment. Sole reliance on an arbitrary list of tax expenditures, on the other hand, will not provide a satisfactory framework for making proper tax policy choices.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) provides an all too clear illustration of this principle. That bill was promoted as a way of closing loopholes and tightening outdated preferences. But it removed over 70 percent of the tax reductions granted to business under the Economic Recovery Tax Act of 1981 (ERTA) and caused many businesses to cancel investment or pension plans. We urge you not to raise taxes again this year in the name of trimming tax expenditures.

Calling certain provisions tax expenditures misdirects Congressional attention. For instance, the tax expenditure for corporate tax rates below the maximum 46 percent rate could be eliminated by lowering the maximum rate to 15 percent (the current bottom rate), or by raising the lesser rates to 46 percent, or by redefining the "normal tax structure" to include graduated corporate as well as personal tax rates. Yet these three solutions would have divergent effects on tax receipts and on the economy. Obviously, the structure of corporate tax rates should be set in the context of desired tax and economic policy, not for the sake of achieving a certain level of tax expenditures.

### DEFINITIONAL PROBLEMS

Section 3(a)(3) of the Congressional Budget and Impoundment Control Act of 1974 defines tax expenditures as "those revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." These provisions are measured with reference to a "normal tax structure for indivisuals and corporations." Although this definition sounds straightforward, in fact any definition of "normal tax structure" concept is completely arbitrary, and even proponents of the tax expenditure concept have disagreed on whether certain provisions are tax expenditures.

Examples of this arbitrariness abound. Graduated rates for individuals are not a tax expenditure, but graduated rates for corporations are. Personal exemptions for taxpayers and dependents are not, but the added exemptions for blind and aged persons are, as in the tax credit for child and dependent care. Other provisions have been variously classified as tax expenditures or as part of the "normal tax structure" from one year to another.

The latest compilation by the staff of the Joint Committee on Taxation (JCT) includes 17 items omitted by the Administration in Special analysis G of the Budget and leaves out one item that the Budget includes. Three other items appear under different budget functions in the two lists. Still other items have different revenue estimates attached to them, and others are omitted for administrative simplicity even though the reports agree that conceptually they are tax expenditures.

One of the most important differenes between the Administration and Congressional lists this year is that the former treats the accelerated cost recovery system (ACRS) as part of the normal or reference tax structure, whereas the JCT treats it as a tax expenditure. We believe that ACRS is a fundamental part of the tax system. As the JCT pamphlet acknowledges, "Even with accelerated depreciation, taxpayers will not always receive deductions whose real value corresponds to the amount they originally paid for the asset." (JCT, "Estimates of Federal Tax Expenditures for Fiscal years 1983-88," Joint Committee Print JCS-4-83, March 7, 1983.) Yet the ground rules for computing tax expenditures do not allow an offset for the negative tax expenditures taxpayers suffer when they are not allowed full cost recovery. Thus, relying on the JCT's estimate of this tax expenditure will lead to overstatement of the deviation from a normal tax structure.

## MEASUREMENT DIFFICULTIES

Even if it were possible to agree on a list of tax expenditures, it would be impossible to measure their cost accurately. The cost of a tax expenditure equals the number of individuals or corporations using the provision times the amount by which their tax liability is reduced. For many tax expenditures, either the number of users or the amount of reduction in their tax liability, or both, is unknown. For instance, municipal bond interest is a tax expenditure because recipients do not have to report the interest on tax returns. However, data are not available on how many individuals hold minicipal bonds, how much interest each receives from his or her holdings, or what tax rate would be applied to those holdings if they were taxable. Therefore the estimated size of the tax expenditure for municipal bond interest is grossly imprecise.

The total "cost" of all tax expenditures cannot be found by adding up the "cost" of each provision. Eliminating one provision, such as the deduction for home mortgage interest, will cause some taxpayers to switch from itemizing deductions to using the standard deduction (zero bracket amount), thereby eliminating several other deductions which are counted as tax expenditures. Moreover, eliminating the deductibility of mortgage interest would leave many taxpayers less able to afford to purchase homes, thereby cutting the use of the deduction for property taxes and several other tax expenditures. Finally, cutting back some provisions may cause taxpayers to switch to another tax expenditure. For all of these reasons, elimination of one tax expenditure would decrease the total for all of them or increase total tax receipts by an amount which differs from the estimated cost of that one provision.

In fact, cutting back on a tax expenditure actually can *decrease* tax receipts in some cases. This can occur if the tightened provision raises taxpayers' effective tax rates to such a high level that they decide it is not worth investing or engaging in that activity. In such cases broadening the tax expenditure leads to a rise in revenues. A recent example is the reduction in the maximum tax rate on capital gains from nearly 50 percent to 28 percent in 1978. In 1979, revenues from capital gains increased, contrary to official forecasts. The revenue increase occurred because the rates under prior law had been so high (especially given that these rates applied to "gains" created solely by inflation) that many taxpayers were discouraged from realizing their gains.

The idea that tax expenditures can be measured accurately assumes a world of statics rather than dynamics. It assumes that individuals do not change their behavior as a result of a change in tax rates or tax structures. Such a notion is intellectually bankrupt. To return to the municipal bond example, if the tax exemption for the bonds were repealed, investors would switch to higher-yielding instruments, driving down the yield on those investments and raising the yield on municipals. The net revenue effect would almost certainly differ from that predicted by the static tax expenditure estimate.

### TRENDS

It is commonly assumed that tax expenditures are growing rapidly, that ERTA led to an expansion of tax expenditures and that TEFRA tightened up on them. The data contradict all of these assumptions.

A comparison of the fiscal 1984 cost for each tax expenditures included in the JCT lists for 1981-83 shows that more tax expenditures decreased in cost than increased from 1981 to 1982, after ERTA was enacted. The opposite result occurred from 1982 to 1983, following passage to TEFRA. Moreover, the total cost of all fiscal 1984 tax expenditures was estimated to have declined by 13 percent from the 1981 estimate to the 1982 estimate, and to have increased by 7 percent the following year. These results are shown in the following table.

## CHANGE IN ESTIMATED FISCAL 1984 TAX EXPENDITURES, BASED ON 1981, 1982, AND 1983 JCT ESTIMATES

| Change in estimates | Number of tax expenditures with | | | Change in all tax expenditures (percent) |
|---|---|---|---|---|
| | Decrease | Increase | No change | |
| From 1981 to 1982 | 65 | 42 | 12 | 13 |
| From 1982 to 1983 | 41 | 45 | 33 | 7 |

Looking at the items that have increased is not necessarily a reliable guide to tax policy. This year, the estimate for net exclusions of pension contributions and earnings showed an enormous increase, yet Congress drastically tightened up the tax treatment of pensions last year, causing many employers to terminate their plans.

### INCOME DISTRIBUTION

Another common fallacy is that tax expenditures benefit mainly the rich. In fact, for four of the five largest tax expenditures (using the latest JCT estimate for fiscal 1984), the benefit goes disproportionately to lower- or middle-income taxpayers, as the table below shows.

## DISTRIBUTION OF TAX EXPENDITURES, FISCAL 1984

| Tax expenditure | Amount (billions) | Percent going to returns with income below $50,000 |
|---|---|---|
| Net exclusion of pension contributions | $56.6 | 74 |
| Deductibility of home mortgage interest | 27.9 | 70 |
| Deductibility of state and local taxes | 21.8 | 53 |
| Exclusion of employer medical premiums | 21.3 | 87 |
| Exclusion of social security benefits | 16.7 | 92 |
| Total income tax, 1981 | 292.7 | 67 |

Sources: Tax expenditures estimated from JCT, March 1983; percent distribution from Treasury letter to Rep. Henry Reuss, Sept. 28, 1982; total income tax from IRS "Statistics of Income Bulletin," Winter 1982-83.

In any case, focusing on the percentage of a tax expenditure that goes to a particular income level can give a misleading impression of the effect that repeal would have. For instance, 55 percent of the tax expenditure for charitiable deductions goes to returns with income exceeding $50,000. But if this deduction were eliminated, charitable giving would drop, and many charitable activities that benefit lower-income individuals would suffer. The net effect would undoubtedly be more severe for those at the lower end than those at the top of the income scale.

### PROLIFERATION AND REVIEW

Critics of the tax-writing process often charge that tax expenditures have been proliferating and, once enacted, are not reviewed. In fact, as a list compiled this year by the Congressional Budget Office shows, many important tax expenditures date back to the beginning of the individual income tax in 1913 or even before. For instance, deferral of income of controlled foreign corporations dates from 1909; individual interest and property tax deductions date from 1913. Seventy of the 104 items on the CBO list are at least 15 years old. Moreover, many of the more recent ones include "sunset" dates insuring that they will be reviewed and not renewed automatically. In addition, the tax-writing committees regularly review and often amend many other tax expenditures. Clearly, those provisions that survive are the result of conscious policy.

### CONCLUSION

We recommend that the Finance Committee continue its careful review of all parts of the tax code without creating distortions by arbitrarily labeling certain provisions as tax expenditures that deserve special scrutiny out of context. We also recommend that the Committee not approve hasty tax increases under the illusion that it is merely reducing tax expenditures.

## STATEMENT OF DR. NORMAN B. TURE, CHAIRMAN OF THE BOARD, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION, WASHINGTON, D.C.

Dr. TURE. Thank you, Mr. Chairman.

These hearings provide the opportunity for a careful examination of the usefulness of the tax expenditure concept and of the meaningfulness of the estimates of tax expenditures.

I believe that the concept of tax expenditures is at best too ambiguous to provide a useful guide for selecting tax provisions which can be identified as the equivalent of direct outlays by the Government.

The statutory language requires a definition of taxable income to provide a standard for determining which tax provisions are "special." The special analysis G language approach depends on a correct definition of "subsidy" to identify tax provisions which should be listed as "tax expenditures"; but, in lieu of such a definition, it attempts to distinguish between normal or referenced provisions of the tax structure and special provisions which are exceptions to those referenced provisions.

The joint committee staff report seeks to identify tax expenditures as provisions in the law and regulations which provide economic incentives or tax relief. To determine whether a tax provision provides an economic incentive, however, requires a rigorous delineation of the pertinent tax treatment which neither inhibits nor artificially encourages the economic activity in question.

The concept of tax neutrality affords a far less ambiguous standard against which to determine whether any tax provisions conveys a subsidy or is a tax expenditure. Neutrality means that the tax does not change relative costs and prices compared to what they would be in the absence of taxes. In this context, the income tax is fundamentally biased against saving and in favor of consumption, because it increases the cost of saving relative to consumption.

Neutrality requires either that saving or capital outlays be excluded from current taxable income, while all of the gross returns are included; or, alternatively, that saving be included in current taxable income while all of the returns are excluded. Using this standard, many of the items on the tax expenditure list clearly are misidentified and should be shown as negative tax expenditures, or negative subsidies.

Among these I would include the exclusion of pension contributions and savings, accelerated depreciation, exclusion of 60 percent of net long-term capital gains, the dividend exclusion, the exclusion of interest on life insurance savings, and the exclusion of interest on State and local government bonds.

The measurement of tax expenditures confronts enormous difficulties. A correct measure of the revenue effect of a tax expenditure is the difference between the amount of the actual tax liability and the tax liability which would arise from the composition and level of economic activity which would prevail in the absence of the tax expenditure. In lieu of this measure, which is very difficult to estimate in the present state of the econometric art, we use so-called "static" estimates. These assume no economic effects of the tax expenditure, and they are therefore almost certainly wrong and misleading.

Moving against tax expenditures on an ad hoc basis almost certainly will result in accentuating the existing income tax bias against saving and capital formation. If, counter to the requirements of economic recovery, revenue raising measures nevertheless are to be enacted this year, they certainly should not be those which will add to the cost of saving and investment.

Thank you.

The CHAIRMAN. Thank you.

[The prepared statement of Norman B. Ture follows:]

### STATEMENT OF NORMAN B. TURE, CHAIRMAN, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION [1]

Mr. Chairman, I am happy to have this opportunity to present, at last, my views on the subject of tax expenditures. My testimony is addressed to the questions of the validity and usefulness of the concept of tax expenditures and of the problems that are posed in trying to measure them. I will attempt to illustrate these conceptual and measurement problems by reference to several of the frequently cited tax expenditures.

Let me digress briefly to urge in the strongest possible terms that whatever conclusions the Committee may arrive at regarding tax expenditures, they should not be used as the rationale for net revenue increasing legislation. The last thing in the world the U.S. economy needs at this early stage in its recovery is a new layer of tax burdens. Tax increases should not be on the Congressional agenda until the recovery is assured, if not indeed complete, at which time a much less conjectual projection than those relied on in the past few years of GNP, current service budget outlays, revenues and deficits will be possible. At that time, if it appears that revenues will continue to lag below expenditures, constructive decisions about the adjustments of these budget magnitudes will be possible.

Eliminating or reducing a so-called tax expenditure is a tax increase, no matter that it is done in the name of tax reform, closing loopholes, or what have you. If reform is truly the objective rather than raising revenue, then any projected revenue gains from eliminating or reducing a tax expenditure should be matched by a reduction in tax rates on the affected taxpayers.

---

[1] The views that are presented here are my own and do not necessarily reflect the views of the Institute for Research on the Economics of Taxation. The title and the name are used for identification purposes only.

## DEFINING TAX EXPENDITURES

Section 3 of the Budget Act defines tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Upon even a moment's consideration, it must be clear that this language finesses the definitional difficulties; it does not resolve them. In short, the statutory language provides no systematic guidance for identifying which provisions are so "special" as to substitute for expenditure authorization and appropriation authority, as constrasted with "general provisions" that are strictly exercises of taxing authority.

Special Analysis G in the Budget of the United States makes a valiant but quite unsuccessful effort to make the concept of "tax expenditures" less ambiguous. The Special Analysis G ploy is to make the term "tax expenditures" synonymous with "tax subsidies." In fact, the subsidy concept would be useful if the word subsidy were properly defined as a device which reduces the relative cost of the subsidized activity, good, or service compared to what its relative cost would be in the absence of government. Relying on this concept would produce quite a different approach to identifying tax expenditures, many of the provisions on the current list would show up as negative tax expenditures, as undue tax exactions.

The concept presented by the staff of the Joint Committee on Taxation is somewhat different from that in Special Analysis G but no less ambiguous.

To characterize any given exclusion, exemption, or deduction as "special" or to conclude that a provision affords a credit that is "special" or a preferential rate of tax or a deferral of tax, we need to have a definition of the nonspecial. Similarly, to identify a tax provision as providing economic incentives we need to be able to delineate a provision which neither inhibits nor encourages the affected activity. For this purpose, we need a rigorous definition of taxable income. It is probably unnecessary to point out that there is no consensus concerning the "correct" concept of taxable income, no more as a matter of analytical abstraction than as a practical guide to tax policy. The "correctness" of any definition of taxable income depends significantly on one's priorities with respect to tax criteria—equity, neutrality, simplicity, adequacy, etc.—and on how one delineates the tax base requirements of each. All of us, of course, agree that the income tax should be fair; few of us have ever agreed on the standards of fairness. The equity standard, therefore, has never afforded a satisfactory guide to defining taxable income, hence to defining provisions of the tax law which may fairly be termed "tax expenditures."

The neutrality criterion leads to quite a different list of "tax expenditures" from that supplied in the budget document and changes the sign of many of them. A tax is neutral only if its imposition does not alter relative costs or prices. On this basis, any income tax is unneutral because it necessarily increases the cost of undertaking the activities which generate income subject to tax compared to the cost of all other activities. Even if one is willing to accept this fundamental unneutrality, one should at least seek the imposition of the tax in such a way as to alter the costs of the alternatives confronting taxpayers in the same proportion. It should raise the cost of saving in the same proportion as the cost of consuming, of working in any particular job in the same proportion as working in any other, of using one kind of production input in the same proportion as any other, etc.

Most of us have come more and more to recognize the desirability and importance of gearing tax policy more closely to the neutrality criterion than we have in the past. Past failures to do so have given us a tax system which has year by year become increasingly punitive of saving and capital formation, of productive, market-directed personal efforts, of enterprise, risk-taking, innovation—of the kinds of activities upon which economic progress and rising living standards depend. Enactment in 1981 of the Economic Recovery Tax Act reflected a broad-based consensus that we must move toward a tax system which conforms with the dictates of the neutrality criterion. Last year's tax legislation was, I believe, an unfortunate retreat. One must hope that that mistake will not be repeated this year and that instead we may soon regain the momentum of a neutrality-oriented tax policy.

It is widely recognized that the personal income tax is fundamentally biased against saving and in favor of consumption, in view of the fact that it levies both on the amount of current income which is saved and also on the future income produced by the current saving. Neutrality requires either that saving be excluded from current taxable income while all of the gross returns on the saving are included or that saving be included in current taxable income while all of the returns are excluded. These are perfectly equivalent and assure that the tax raises the cost of saving in the same proportion as it raises the cost of consumption. To the extent, and it is substantial, that the present income tax fails to follow either of these alternatives, it imposes a negative subsidy on saving. Any provision which abates the tax on saving or on the returns on saving should be treated as a reduction in a negative subsidy.

In the light of this criterion, consider the designation as a tax expendiure of the net exclusion of pension contributions and earnings, the largest single tax expenditure in Special Analysis G and in the Joint Committee Staff's listing. Against the basic test of tax neutrality between saving and consumption, these exclusions should be seen as major ameliorations of the anti-saving tax bias, of the tax expenditure in favor of consumption. They have no place in a listing of exceptions from the normal, if normal is interpreted, as it should be, as leaving the relative costs of saving and consumption the same as they would be in the absence of the tax.

Just as difficult to justify is the inclusion of "accelerated depreciation on equipment" or the depreciation on buildings in excess of straight line in the Joint Committee staff listing. The neutrality criterion calls for true expensing of the costs of any and all capital facilities. This means that these costs must be effectively deductible as they are incurred against all of the taxes which apply to the returns on these facilities. The Accelerated Cost Recovery System (ACRS) falls short of satisfying these requirements; ACRS allows capital recovery deductions only beginning in the taxable year in which the facilities are placed in service which often is several taxable years after some of the costs for acquiring the facilities are first incurred. The ACRS deduction, moreover, are not generally allowed against all of the taxes bearing on the income produced by the facilities; if the facility is owned by a corporation, for example, the ACRS deduction does not offset the individual shareholder's tax liability on the dividends he receives, paid out of the income produced by the facilities. And the deductions may well exceed income and have to be carried forward, so that their present value falls short, possibly substantially so, of their nominal value. So-called accelerated depreciation should be seen as a negative tax expenditure insofar as the actual present value of those deductions is less than the present value of true expensing.

It has been shown elsewhere [2] that a substantial additional deduction or investment tax credit would have to be added to ACRS deductions to provide equivalence with the true expensing called for by the neutrality criterion. For this reason, neither accelerated depreciation nor the investment credit belong on a list of tax expenditures.[3]

Against the standard of neutrality, any tax on capital gains is a negative tax expenditure; any reduction in that tax should be seen as reducing an extraordinary tax penalty. A capital gain is the capitalized value of an expected increase in the income to be produced by the asset; since that income will be taxed as it arises, taxing the capital gain is taxing the same income flow twice. In the case of corporate stock, capital gains generally reflect the corporation's retention of earnings. Since those earnings have already been taxed to the corporation, taxing gains realized on such stock compounds the multiple taxation of the returns on capital.

These examples of misidentifiction of tax expenditures can be extended far beyond the limits of the Committee's time. To cite only a few of the items which certainly are not tax expenditures in the light of tax neutrality, the $100 dividend exclusion and the exclusion of interest on life insurance savings surely do not belong on any tax expenditure list. Nor should the exclusion of interest on any state or local bond, whether general purpose debt, small issue industrial revenue bonds, mortgage revenue bonds, etc., be treated as tax expenditure unless it could be shown that the income used to purchase these bonds was itself excluded from the income tax base.

Unfortunately, those compiling tax expenditure lists are uninhibited by any rigorous conceptual requirements. The ambiguity of concept in these lists is revealed by the facts that the lists change from time to time and that lists offered by different compilers often differ. The Joint Committee staff compilation includes 17 items which are not included in Special Analysis G, but no explanation of the reasons for the differences in listings is provided.

---

[2] Cf. Norman B. True, New Directions for Federal Tax Policy for the 1980's, American Council for Captital Formation, Ballinger Publishing Company, Cambridge, MA, forthcoming.

[3] Presumably the justification for including these provisions is that they afford capital recovery deductions at a faster rate and in greater amount than so-called "economic depreciation." Economic depreciation is an abstraction which cannot be applied in any real life situation; indeed, it is inherently so ambiguous as to be of little if any use even for abstract analyses. CF. Ture, op. cit.

Some of the items on one or another list elude any justification. The Joint Committee staff list, for example, includes "Reduced rates on the first $100,000 of corporate income" as a tax expenditure. There is a wide consensus that the entire corporate income tax is a negative tax expenditure, one of the principal violations of tax neutrality, and a major source of distortion in the use of capital and labor production resources. To treat corporate tax rates less than the top marginal rate as a tax expenditure defies reason. Should one infer that there is some inherent correctness in 46 percent as the rate at which income generated in corporate business is correctly taxed? If so, were prior rates of 48 percent and 52 percent, by any such implied criterion, negative tax expenditures? What logic dictates that taking only 15 percent from a company which earns $24,999 is to provide that company a subsidy—the equivalent of a government expenditure of funds in the form of a $7,750 grant to that company?

If we can find any such justification, why don't we include in this list of tax expenditures all bracket rates in the individual income tax less than the present top 50 percent? But why set 50 percent as the "normal" rate? Why not set 100 percent as the standard and treat all exactions from taxpayers at lesser rates as the equivalent of the government giving them money?

The conceptual frailties of tax expenditures argues strongly against relying on any listing as departures from "normal," "standard," or what have you, still less as the equivalent of budget outlays. Many of the usually listed items could be justified as tax subsidies or tax expenditure only if one believes that the "right" tax should discriminate against saving, in favor of consumption. Others require some as yet unavailable delineation of the "right" rate or rates of tax or the "right" timing of tax liability or the "right" taxpaying unit. In short, the usual lists should be regarded as arbitrary and capricious, at the least, and in large part counter to an emerging consensus in favor of neutrality as the principal criterion of tax policy.

## MEASURING TAX EXPENDITURES

Even if the imprecision and ambiguities of defining tax expenditures are disregarded, enormous difficulties are confronted in attempting to measure them. Presumably the amount of any given tax expenditure is the revenue which the government doesn't collect because the specific provision of the law differs from what is the "correct" or nonspecial treatment. Whereas one can relatively unambiguously designate a specific amount to be spent on a direct government expenditure, no comparably unequivocal estimate can be provided for a tax expenditure.

The correct measure of the revenue effect of a tax expenditure is the difference between the amount of actual tax liability, on the one hand, and the tax liability which would have arisen from the composition and level of economic activity which would prevail in the absence of the tax expenditure, on the other. Unless one assumes that taxpayers' behavior would be identical with and without the tax expenditure, the measurement of the tax expenditure requires identifying and measuring the changes in the composition and volume of economic activity which occurred in response to the tax expenditure and how these changes affected tax liabilities. While this concept of "feedback" effects has become familiar and widely accepted in recent years, the limited capacity to measure them in the present state of the econometric art has forced reliance on so-called static or first-level revenue estimates for measuring tax expenditures. But these static estimates necessarily assume no economic effects are produced by the tax expenditure; they are almost certainly, therefore, wrong and are highly misleading.

Beyond these fundamental measurement problems, there are substantial mechanical difficulties to be confronted in attempting to measure tax expenditures. For one thing, it is not possible to add all tax expenditures into a meaningful total. Each tax expenditure provision must be estimated independently to avoid making the estimates depends on the sequence by which provisions are conceptually eliminated from the Internal Revenue Code in making the estimates. As a result, tax expenditures as currently measured are not additive. For example, if two "speical" exclusions were considered jointly, the elimination of the exclusions together would push individual taxpayers into higher tax brackets than if each exclusion were considered separately. The revenue loss (tax expenditure) from the provisions considered jointly is greater than the sum of the revenue losses from considering them separately, and there is no clear way to allocate the greater joint total between the two provisions. The reverse is true for itemized deductions, since considering two or more in combination would cause more taxpayers to use the zero bracket amount, or standard deduction (which has not been considered a tax expenditure) than it these deductions are considered one at a time. Again, it is not clear how to allocatae the lower joint total among itemized deductions.

In addition, tax expenditure estimates differ from estimates of the potential revenue gain from repeal in that tax expenditure estimates treat provisions as if they are permanent features of the Internal Revenue Code, although many are not, and because of the timing differences between changes in tax liabilities and changes in tax receipts.

### COMPARABILITY OF DIRECT EXPENDITURES AND TAX EXPENDITURES

The very term "tax expenditures" implies that the foregone revenue is essentially the same as a direct outlay by the government. As I have noted, it may be possible to estimate an "expenditure equivalent," but it will rarely, if ever, be the case that a tax provision is actually equivalent to an outlay program. Direct outlays by the government for purchase of goods or services involve a direct preemption of the production inputs used to produce the goods or services the government buys. Tax expenditures never involve such a direct impact on the use of production inputs. Tax expenditures and direct subidies have their effects through changes in relative costs and prices and the responses to these changes. However, in the case of tax expenditures, the pattern of price changes will be different from those produced by direct expenditures. Moreover, the magnitude of the change in the use of production inputs induced by the "tax expenditure" cannot always be inferred from the amount of the estimated revenue loss.

### CONCLUSION

The preceding discussion of the conceptual and measurement frailties of tax expenditures argues against treating any listing of these items as an inventory of "special tax breaks." Constructive revision of the tax system cannot proceed on the basis of eliminating or reducing either the most quantitatively impressive or most vulnerable provisions on the list. The real and critical deficiences in the existing income tax system arise from the continuing bias against private sacing and capital formation, not from the selective amelioration of that bias. A well conceived frontal attack on the basic sources of that anti-saving bias would lead us to a uniform, expenditure-based, flat-rate tax in which many of the so-called tax expenditures would simply and automatically disappear. But that is the only constructive route toward the elimination of these provisions. Indeed, it is the only route toward a correct and logical identification of what is and what isn't a tax expenditure.

Moving against the conventionally identified tax expenditures on an ad hoc basis almost certainly would result in accentuating the existing tax bias against saving and capital formation. No tax increase, in my judgment, is warranted now. If, notwithstanding, revenue raising measures are to be enacted this year, they certainly should not be those which will add to the costs of saving and investment. Special Analysis G and the Joint Committee staff's listing should not be seen as a potential agenda of revenue raising measures. They are, at best, fiscal curios.

The CHAIRMAN. Senator Long.

Senator LONG. Dr. Ture, I think you made a good statement, and I tend to agree with you about that matter, but I want to ask you this: You are a witness who, more strongly than anyone I know, made the case that we ought to have this 3-year tax cut, and that we were going to have a great stimulation of the economy which was going to bring us additional revenue. Why didn't it work out that way?

Dr. TURE. Well, if the committee has about another two and a half hours, I would be happy to summarize my views on that subject.

Senator LONG. Could you summarize the summary of it? Why didn't we get the results we were looking for with that tax cut?

Dr. TURE. One, I think that we misapprehended grossly how severe the economic problems were that we were in at the beginning of 1981. There was a widespread impression that we were at the beginning of a strong recovery phase; we were not. We were in the middle of a recession that began late in 1978, at the very latest early in 1979, from which there was no significant recovery at all.

I think there was a gross misapprehension; I think I am guilty of having been a participant in that misapprehension and having poorly advised the President in that respect.

Second, one of the conditions that we laid out as absolutely essential for the fiscal policy which the President recommended, working toward promoting economic recovery and long-term economic progress, was a quite different approach to monetary policy from that which we had experienced for several years past. What we called for was a much more moderate growth in the stock of money, and above all a much more stable growth in the stock of money. We got neither during 1981 or 1982 and so far this year. Monetary policy has pursued, of course, an enormously rapid expansion, followed by very stringent slow growth, followed by a resurgence of expansion, more slow growth. Nothing that I can think of is better designed to confuse and to impair the effectiveness of the operation of our capital markets.

Putting those two conditions together, it seems to me that our earlier assumptions about how effective the income tax reductions which we proposed would be in promoting economic recovery were over-optimistic.

Senator LONG. Could I just ask Dr. Walker to give me his reaction to that same question?

Dr. WALKER. I would agree with much of that. I would emphasize a couple of other points.

The basic estimates that were made on the revenue impact and the revenue results of the tax cuts were not those given so much play in the press of the so-called supply-siders—that we were going to have a gush of revenues.

When you take what was sent up in the Economic Recovery Tax Act, the combination of spending restraint and tax cuts, I'm not sure that those revenue estimates were all that much off—given the length and severity of the recession.

As I see the basic failure of policy, I would not put as much on the monetary side as Dr. Ture does. The basic thrust of Reaganomics fiscal policy was to be, over a 5-year period 1981-86, a reduction in both Federal spending and Federal taxes to about 19 percent of GNP. We succeeded on the tax side; we failed miserably on the spending side. The two got out of whack. That's the basic problem that has to be be rectified. Still, with inflation coold and recovery gaining strength, the Reagan economic game plan is beginning to pay off.

Senator LONG. Thank you.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. No questions.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. We have a problem here. We have been directed by the vote of the Congress to come up with $72 billion over 3 years. And it is all well and good to say "don't do this," and "don't do that," and I would like a little guidance in what we should do.

I missed Dr. Walker's testimony—I was trying to catch up—but, as I understood, did you say we should go to a value-added tax?

Dr. **Walker**. No, I did not. I said that opinion is growing among tax experts and public officials that in order to fund the government in a viable way, because of the problems with the income tax, we have to move toward a broadbased consumption tax. A value-added tax is one approach to a broadbased consumption tax; there are others.

Senator **Chafee**. You know, we have witnesses come before us—and I'm not chastising anybody because I'm in no position to do that—but we have witnesses come before us constantly that point out the marvelous things that are happening in other countries. It must be selective testimony; in other words, "Great things are happening in Britain as far as what the rate of depreciation is." Was that in Mr. Huard's testimony? Or was it in yours, Mr. Franasiak?

Mr. **Franasiak**. No, it was in Mr. Huard's.

Mr. **Huard**. It was in mine, Senator.

Senator **Chafee**. Sweden and Britain and Germany—if that's all true, why aren't they doing better? Maybe they have other problems that off-balance what these wonderful depreciation schedules do.

Let's take Britain—that's an easy one to kick around. What do you say about Britain?

Mr. **Huard**. The thrust of my testimony was to point out not that various European countries were doing wonderfully relative to us, but instead related to the concept of what is or is not part of a normal tax structure. And I was trying to suggest many of the provisions shown by CBO or the Joint Committee on Taxation as abnormal deviations from a normal tax structure are in fact in use in virtually all Western industrialized countries such as Sweden, Great Britain, and those I enumerated.

I was just trying to make the point that maybe these things ought to be considered normal. I wasn't trying to make the point that they have worked so wonderfully in these other countries.

Senator **Chafee**. What do you think would happen if we went to expensing of all equipment—just dropped all depreciation schedules, let everyone expense or depreciate on the rate they wanted to, but once they started they had to stick to it?

When I was in law school that was Dean Griswold's theory—let everybody do it the way they wanted, but they couldn't change. Now, would that just ruin the Treasury?

Mr. **Huard**. Well, it would have the argument of eliminating the argument that ACRS is better than expensing, which might affect employment and the joint committee staff somewhat. [Laughter.]

I think the biggest problem, obviously, is the transitional problem.

Senator **Chafee**. Do you mean the first year would be devastating to the——

Mr. **Huard**. That is correct. You need some kind of stretched-out transitional period. I think there is a lot to be said for the expensing concept. I do think that the most difficult problem, indeed the only one that I see as a fundamental difficulty, is the transition period. You just can't widen the gap between the Government's income and expense that fast, in one year, which is what would happen with immediate introduction of expensing; you have to have a phase-in. And that really is the problem.

Mr. **Franasiak**. Senator, may I also add that our members, at least the ones that use ACRS to a great degree, are just simply strapped in terms of planning and trying to plan several years in advance as they have to do at some of these very large capital projects. They are trying to figure out what their cashflow is going to be, what their return on investment is going to be, and the rest. Changing the tax law every year certainly doesn't help them any in this regard. And I would expect that if we change ACRS the third time, 3 years in a row, we are going to have even more confusion and probably a little bit less investment in that area.

So I would urge that we just leave it where it is for a while and see how it works. I think that we are going to see a pickup in business investment: we have had some. To constantly be changing the law in this very fundamental way for something that is as important as capital expenditures is detrimental to the long-term interests of economic growth.

Senator **Chafee**. Do you have any suggestions on how we might pick up $72 billion in 3 years?

Mr. **Franasiak**. Well, I think the fundamental point has to be made. Once again, last year we went through an exercise of increasing taxes. We were going to get $3 of spending cuts for every $1 of tax increase. Many members of the business community supported that; some did not. We ended up getting substantially less than that; we ended up getting between 40 and 50 cents——

Senator **Chafee**. I am not trying to cut you off, but could you direct yourself to that specific question? Where do we get $73 billion? Is it 72 or 73? What's a billion? Make it 72. [Laughter.]

Senator **Durenberger**. You voted for it; you know.

The **Chairman**. We didn't vote for it. We don't know.

Mr. **Franasiak**. I would think one area to get a bit of revenue is simply in terms of this economic recovery that we are beginning to experience. Certainly everybody's projections are being moved up, and even the most optimistic optimists are beginning to look at growth rates which we hadn't seen in the last several years, the last couple of decades.

Senator **Chafee**. You mean the most pessimistic pessimists, I think, not the optimistic optimists. They've thought it was good all along.

What do you say, Dr. Ture?

Dr. **Ture**. Your question is a difficult one, sir, because I would very strongly urge that this is not—contrary to the budget resolution—the time to raise taxes at all. At the very least, one ought to wait until the economy's recovery is substantially completed, or so solidly in place that there are no remaining doubts about its virility. There are such doubts today, and I think they are reasonable ones.

I would suggest that your target year for reconsidering whether or not there have to be basic adjustments in the budget magnitudes, particularly whether or not you have to raise taxes relative to expenditures, is 1986. And I wouldn't lay a hand on it until then—against all directives to the contrary from other committees of the Congress.

Senator **Chafee**. Well, it wasn't other committees; it was the vote of Congress.

Dr. Walker.

Dr. WALKER. Could I come in? I agree fully with Dr. Ture that 1986 is the problem period, and we may get a lot more out of economic growth than people think. Just by the flick of the hand, in the last few days, in the forecasts that the administration now has, according to Dr. Feldstein yesterday, economic growth will probably reduce the 1984 deficit by $10 to $15 billion. If it's $15 billion, that's more than the $12 billion called for in the revenue reconciliation provisions of the fiscal year 1984 budget. So I think we need to buy some time here. We could have a very strong, long-lasting economic recovery.

I personally think that the best way to buy time is to hold off any tax increases right now. I think they would be the wrong kind. I don't think you would get the spending restraint you need. Tax increases might be dissipated in more spending so that you don't reduce the deficit.

Senator CHAFEE. Well, I don't think that's a fair statement to make. What are you saying? That if we increase taxes, that the Congress will gobble it up in spending?

Dr. WALKER. I am saying this, that in 1974 Federal receipts were $260 billion, with a $5 billion deficit. This year they are expected to be $600 billion—2½ times as much—with a $200 billion deficit, 40 times as much. We have had revenues almost triple, and it hasn't caused the deficit to go down. The other way around—if you don't have the spending restraint, yes, it will be gobbled up.

I favor a commission approach, Mr. Chairman. I think a blue-ribbon bipartisan commission like the Social Security Commission should be established at the end of this year to report back in January 1985 when we have had time to see what we need.

Senator CHAFEE. All right, thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Do you mean you want to replace Congress with a commission?

Dr. WALKER. No, sir, I want to recommend a commission to the Congress, like the Social Security Commission, like you were on.

[Laughter.]

The CHAIRMAN. Yes, I was on that Commission.

Well, as long as you don't replace Congress. If you did, we wouldn't have anybody to kick around.

[Laughter.]

The CHAIRMAN. The chamber of commerce would be out of business.

[Laughter.]

The CHAIRMAN. We appreciate your testimony. We are looking at additional areas of tax reform, as we did last year, and we appreciate the support that we had generally from the business community and the responsible members of the business community.

But we do have a problem, you know. We can't take the resolution that passed lightly—even though I didn't vote for it. I tend to share the view of all of the witnesses who testified, but our side didn't prevail. Now, I guess we don't go to jail if we don't raise the $73 billion. We are supposed to do it by July 22. We have 2 or 3 weeks yet to work it out, so if anybody in the audience wants to volunteer a few billion——

[Laughter.]

The CHAIRMAN. But no one is going to come here and do that, and that's why it is going to be difficult, if in fact it can be done. We are waiting for some signal from the White House, and the signal was the President left town, I guess. [Laughter.]

Thank you.

Our final panel is Edward Davey, executive director and general counsel, Association of Private Pension and Welfare Plans; and Dallas Salisbury, executive director—do you get paid for all of this? Coming up here?

Mr. SALISBURY. Quite dearly, Mr. Chairman.

The CHAIRMAN. Please summarize your statement if you will.

## STATEMENT OF DALLAS L. SALISBURY, EXECUTIVE DIRECTOR, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, D.C.

Mr. SALISBURY. Senator, I would be pleased to make it short.

The CHAIRMAN. OK, we'll go with you first, then.

Mr. SALISBURY. Good morning.

Statistics can be used in many ways. For example, discussion of total employee benefits being 32 to 37 percent of compensation can create deceptions and historic misperceptions. In 1981 tax-favored employee benefits, for example, totaled only 8.8 percent of pay.

Percentage and dollar figures must be considered in context. For example, Joint Economic Committee studies indicate clearly that tax incentives for employee benefits are among the most equitable in the entire tax code with regard to providing benefits across the income spectrum.

Discussion of tax expenditures as reliable dollar figures as well can be very misleading. First, the numbers don't take into account changes in behavior that always accompany a change in the tax law, thus overstating revenue gains from any change that might be made.

Second, the computation approach for tax-deferred benefits ignores that taxes not received this year would be received in the future. It also biases tax expenditure estimates upward by failing to consider rising earnings of the work force and the fact that the pension system is not yet anywhere close to maturity.

Third, the numbers are an unreliable policy guide due to unexplained significant variations from year to year, and significant inconsistencies in calculations for different types of benefits. For example, the difference in calculation techniques between employer pensions and individual retirement accounts.

Fourth, in some cases, the tax expenditure numbers effectively condemn the employer for responding to Government policy dictates. For example, the Employee Retirement Income Security Act, in the name of benefit security, required minimum funding standards. Employers responded and their increased contributions significantly increased tax expenditures.

Fifth, the numbers confuse by lumping together private and public employee pensions. These numbers should be separated in assessing any employee benefits policy, and so it should be dictated that they be calculated with a uniform set of assumptions.

In conclusion, Senator, consideration of the effect of behavioral changes that might accompany tax law changes, and of the structure of other tax code provisions that affect the estimates, should be undertaken seriously.

Consideration of the life cycle structure of earnings, benefit accruals, and marginal tax rates that provide a radically different distribution of the tax expenditures than cross-section analysis, is essential.

Finally, inconsistencies in the actual calculation of these estimates, to say nothing of the significant methodological deficiencies in the calculation procedure, must be explored.

We are not here today to argue over whether or not there is such a thing as a tax expenditure. As an analytic approach for the Congress it may well be appropriate. We are suggesting, however, that the concept needs to be carefully considered and that the numbers need to be tested thoroughly for their veracity. The Congress needs a bases of facts on which to base decisions.

The Institute currently has a major study underway looking at many of these issues, which we will be pleased to share with the Congress upon its completion.

Thank you.

The CHAIRMAN. Thank you, Mr. Salisbury.

[The prepared statement of Dallas L. Salisbury follows:]

## STATEMENT OF DALLAS L. SALISBURY, EXECUTIVE DIRECTOR, AND SYLVESTER J. SCHIEBER, PH. D., RESEARCH DIRECTOR

### INTRODUCTION

Mr. Chairman, it is a pleasure to appear before you today. I appear in my capacity as Executive Director of the Employee Benefit Research Institute. With me is Dr. Schieber, EBRI's Research Director. EBRI is a nonprofit, nonpartisan, public policy research organization founded in 1978. EBRI sponsors research and educational programs in an effort to provide a sound information basis for policy decisions. EBRI as an institution does not take positions on public policy issues.

We are pleased to address the Committee concerning "tax expenditures," especially those pertaining to employee benefits. During the last two years there have been significant changes in federal tax laws affecting employer sponsored benefit programs and individually established retirement programs. The Economic Recovery Tax Act (ERTA) of 1981 expanded the availability of Individual Retirement Accounts (IRAs) to include workers already covered by a pension plan. The Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 reduced tax-exempt contribution limits for many private plans.

These and earlier provisions for the U.S Tax Code have been the subject of much discussion and debate in recent years. The dialogue has often centered on the impact that favorable tax provisions for employee benefits have on federal tax collections. Many believe that these provisions help insure the general public's welfare during their working lives and help provide income security during retirement. Others think they are excessive or totally unwarranted.

The discussion of these issues is now taking on a sense of heightened proportions for two reasons. The first is that the Federal Budget continues to be plagued by unprecedented deficits, meaning that all tax incentives will be subject to closer scrutiny. The second is that cost of these tax incentives for some categories of employee benefits have been significantly increased in the 1984 Budget over prior Budget estimates. Virtually no explanation was provided for these precipitously higher estimates.

### CONCEPTUAL BACKGROUND ON TAX EXPENDITURE

As the Budget of the United States Government is prepared each year a set of "tax expenditure" estimates is developed by the Treasury Department and published as part of the Budget. The "tax expenditure" concept was first laid out in 1967 by Stanley S. Surrey, the Deputy Assistant Secretary for Tax Policy at Treasury from 1961 to 1969. He stated:

> Through deliberate departures from accepted concepts of net income and through various special exemptions, deductions and credits, our tax system does operate to affect the private economy in ways that are usually accomplished by expenditures—in effect to produce an expenditure system described in tax language.
>
> When Congressional talk and public opinion turn to reduction and control of Federal expenditures, these tax expenditures are never mentioned. Yet it is clear that if these amounts were treated as line items on the expenditure side of the Budget, they would automatically come under close scrutiny of the Congress and the Budget Bureau.[1]

The Congressional Budget Act of 1974 (Public Law 93-344) formally institutionalized "tax expenditures" as part of the regular budget document. The act defined tax expenditures as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[2] Within this context, tax expenditures are defined as "exceptions to the normal structure" of individual and corporate tax rates.

A problem with the concept of tax expenditures is that the tax code does not include a definition of the "normal structure" of the tax system. As the 1983 Budget points out, the term itself is "unfortunate in that it seems to imply that Government has control over all resources. If revenues which are not collected due to 'special' tax provisions represent Government 'expenditures,' why not consider all tax rates below 100 percent 'special,' in which case all resources are effectively Government controlled?"[3] As a result the practical definitions that have arisen in the measurement of annual tax expenditures are not always consistent within or across categories, or from year to year.

### THE MAGNITUDE OF TAX EXPENDITURES FOR VOLUNTARY EMPLOYEE BENEFIT PROGRAMS

The 1984 Budget of the United States Government submitted to the Congress by the Reagan Administration listed ninety-five separate categories and estimates of the related tax expenditures arising from special provisions in the United States Tax Code. Each of the special provisions in the tax code that gives rise to a tax expenditure represents a decision by the Congress to provide preferential tax treatment for a specific kind of activity. For example, the tax deductibility of home mortgage interest expenses represents a decision by the Congress to provide a tax incentive for individual home ownership. This provision in the tax code does not actually represent a direct expenditure by the Federal Government, but does result in lower total taxes being collected under the individual income tax, all other things being equal. The 1984 Budget estimate of the tax expenditure arising because of the deductibility of mortgage interest on owner-occupied homes during fiscal 1983 is $25.1 billion dollars.[4] This does not mean the government will provide homeowners with $25.1 billion this year, but rather that homeowners would have to pay $25.1 billion more in federal income traxes if their mortgage interest were not deductible, and if they did not change their behavior in any way relative to the tax code if this provision were eliminated.

It is not the purpose of this testimony to focus on the whole range of tax expenditures listed in the Budget but rather to evaluate those that pertain to employee benefit programs established by employers on a voluntary basis. The major categories of programs and the estimated tax expenditures related to each are shown in Table 1. More than 90 percent of the total tax expenditures for voluntary employee benefit programs can be attributed to either pension programs or health benefit programs sponsored by employers.

---

[1] Stanley S. Surrey in a speech to Money Marketeers, New York City, Nov. 15, 1967.

[2] Special Analysis Budget of the U.S. Government Fiscal Year, 1983 (Washington, D.C.: Office of Management and Budget, 1982) p. 3

[3] Special Analysis Budget of the U.S. Government Fiscal Year, 1983 (Washington, D.C.: Office of Management and Budget, 1982) p. 3.

[4] Special Analysis Budget of the U.S. Government Fiscal Year, 1984 (Washington, D.C.: Office of Management and Budget, 1983) p. G-32.

## HEALTH BENEFITS TAXATION

There are basically three reasons why employers are willing to sponsor health insurance programs. The first reason, and this ranking does not infer that it is the primary motivation, is that a healthy workforce will be more productive than an unhealthy one. The second is that the employer can purchase health insurance on a group basis and realize significant economies of scale for the group that they could not realize as individuals. As a result, the aggregate cost of insurance is reduced for a given level of coverage. The third reason is that the purchase price of the health insurance is tax deductible if purchased through an employer's health benefit plan but is not so deductible if it is purchased individually. Recently there has been considerable discussion of changing the tax treatment of health benefits programs.

TABLE 1.—FEDERAL REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" FOR SELECTED VOLUNTARY EMPLOYEE BENEFIT PROGRAMS

[In millions of dollars]

| | Fiscal years | | |
|---|---|---|---|
| | 1982 | 1983 | 1984 |
| Exclusion of contributions to prepaid legal services plans | $20 | $25 | $25 |
| Investment credit for ESOP's | 1,390 | 1,250 | 1,375 |
| Exclusion of employer contributions for medical insurance premiums and medical care | 16,365 | 18,645 | 21,300 |
| Exclusion of pension contributions and earnings: | | | |
| Employer plans | 45,280 | 49,700 | 56,560 |
| Plans for self-employed and others | 2,835 | 3,755 | 4,230 |
| Premiums on group term life insurance | 2,035 | 2,100 | 2,259 |
| Premiums on accident and disability insurance | 120 | 115 | 120 |
| Income of trusts to finance supplementary unemployment benefits | 10 | 5 | 5 |

Source: Special Analysis Budget of the U.S. Government Fiscal Year, 1984 (Washington, D.C., Office of Management and Budget, 1983) p. G–32.

Probably the primary argument used today for reducing the tax preferences for employer-provided health insurance is that it would reduce the comprehensiveness of insurance being provided. The literature is rich with analyses that show that more comprehensive coverage leads to increased utilization of health care services. It is argued that lowering the tax preferences will reduce the comprehensiveness of coverage, and thus, utilization levels. One rationale is that lower service utilization levels will dampen the well-known inflationary problem in health care prices.

Opponents of this logic argue that it is overly simplistic. They argue that given the inflation rate in this segment of the economy it is unlikely many will reduce the comprehensiveness of their coverage in response to changing tax preferences. This is especially the case for hospital coverage, a prime engine in medical cost inflation. On the other hand, physician coverage, preventive service coverage and dental and vision care coverage, where prices have been relatively stable, may be particularly vulnerable to changes in the tax provisions.

Neither of these arguments is well founded in the research literature. Thus another rationale may ultimately be crucial in determining the outcome of this issue. The consideration that might ultimately be of greatest significance is the need for added federal tax revenues. The 1984 Budget ranked the exclusion of employer health insurance contributions fourth among potential sources of new federal revenues during fiscal 1983. These revenue estimates, however, are extremely sensitive to assumptions about employer contribution rates and the particular taxing options that are being considered. For example, in a CBO analysis of various tax cap levels, raising the cap from $1,980 to $2,160 for family coverage and from $792 to $864 for individual coverage, an increase of 9 percent, would reduce the potential tax revenue from the cap by 22 percent.[5]

The sensitivity of the estimates to even relatively small changes in the level of the proposed cap reflects the relatively narrow range of employer contributions. There is little variance in the dollar amount of employer contributions across workers' earnings levels. That means that modest adjustments to the health benefits' tax cap can affect a large proportion of the workers who receive such benefits.

---

[5] Computed from estimates presented in: Congress of the U.S. Congressional Budget Office, "Containing Medical Care Costs Through Market Forces" (May 1982), p. 35.

Because employer contributions are relatively constant, irrespective of income or earnings level, employer contributions for health insurance benefits represents a larger percentage addition to family income at lower income levels than for workers who are better off. Limiting or eliminating the tax incentives for employer health benefits, therefore, will place a relatively heavy burden on workers at lower income levels. At the same time, it is highly questionable whether the revised tax policy would result in less comprehensive hospital care coverage, the areas of greatest health care cost inflation. In any event, the marginal effect of the tax cap legislation on budget deficits of $170 to $180 billion would be minimal.

One concern that policymakers should have if they view changes to the tax treatment of employee health benefits as a potential revenue source is that the tax expenditure estimates are based on assumptions that behavior will not change if current tax provisions are modified. For example, consider the case of an employer who is providing family health insurance coverage that costs $200 per month for a married employee. The estimates of the revenues to be gained by a tax cap generally assume that such a cap of $170 per month, as an example, would not result in different health benefits provisions under the modified tax treatment. That is, that the employer would continue to provide family health insurance that would cost $200 per month, $30 of which would be taxable income. Yet on the cost control side, proponents assume the tax cap would result in less comprehensive coverage. Less comprehensive coverage should be less expenseive, reducing the premium rate below $200, possibly even to $170, thus eliminating the estimated revenue gain. Even if the employer cost did not decline, there is the possibility that the portion of the premium that would become taxable would be shifted to another employee benefit still receiving preferred tax treatment. In this latter case, the tax cap might have no effect on either revenues or behavior.

### RETIREMENT PROGRAM TAX EXPENDITURES

The largest single category of tax expenditure in the 1984 Budget is that attributed to the deferral of tax on employer pension plan contributions and earnings.

In the case of private retirement program tax expenditures the Treasury estimates the federal tax revenue losses that arise because pension and IRA contributions and the fund earnings are not taxed currently even though taxes will be paid when benefits are ultimately paid. The theoretical basis for these estimates is that if employer contributions to pension trusts or individual contributions to IRAs, or investment earnings on the assets were taken as regular income, additional tax obligations would arise at the time the contribution is made or when the investment return is paid. The amount of this particular tax expenditure, however, is not simply current reductions of tax revenues but should recognize that there will be future tax collections at the point of distribution and thus, at least in part, represents taxes deferred not taxes foregone.

Consider the case of a worker who is in the 50 percent marginal tax bracket and is ten years from retirement. Assume this worker has $1,000 in pre-tax income that can be invested in one of three ways: (1) a regular savings account; (2) a pension plan; or (3) an investment vehicle where all return on the investment is ultimately realized as a capital gain. Assume that the annual rate of return in each of these options would be 10 percent per year.

If the $1,000 in pre-tax income is to be invested in a regular savings account then taxes have to be paid on the initial income, meaning that only $500 will actually be deposited in the account. In each year, as the account accumulates interest taxes will also have to be paid on the annual returns. The value of the account at the end of each year over the ten years is shown in the regular savings account column in Table 2. At the end of ten years this account would accumulate to a value of $814.45 under the posited assumptions and would be payable to the holder without any additional tax obligations.

TABLE 2.—HYPOTHETICAL ALTERNATIVE INVESTMENTS AND RETURNS FOR A WORKER IN 50 PERCENT TAX BRACKET

| | Regular savings account | Pension account contributions | Tax expenditure in given year | Capital gains vehicle |
|---|---|---|---|---|
| Pre tax income | $1,000.00 | $1,000.00 | | $1,000.00 |
| Post tax income | 500.00 | 1,000.00 | $500.00 | 500.00 |

## TABLE 2.—HYPOTHETICAL ALTERNATIVE INVESTMENTS AND RETURNS FOR A WORKER IN 50 PERCENT TAX BRACKET—Continued

| | Regular savings account | Pension account contributions | Tax expenditure in given year | Capital gains vehicle |
|---|---|---|---|---|
| Value of account at end of year: | | | | |
| 1 | 525.00 | 1,100.00 | 50.00 | 550.00 |
| 2 | 551.25 | 1,210.00 | 55.00 | 605.00 |
| 3 | 578.81 | 1,331.00 | 60.50 | 665.00 |
| 4 | 607.75 | 1,464.10 | 66.55 | 732.05 |
| 5 | 638.15 | 1,610.51 | 73.21 | 805.26 |
| 6 | 670.05 | 1,771.56 | 80.53 | 885.78 |
| 7 | 703.55 | 1,948.72 | 88.58 | 974.36 |
| 8 | 738.73 | 2,143.59 | 97.44 | 1,071.79 |
| 9 | 775.66 | 2,357.95 | 107.18 | 1,178.97 |
| 10 | 814.45 | 2,593.76 | 117.90 | 1,296.88 |
| Cash distribution | 814.45 | 2,593.76 | | 1,296.88 |
| Tax liability on final distribution | | 1,296.88 | | [1] 159.38 |
| Disposable balance | 848.45 | 1,296.88 | | 1,137.50 |

[1] This is the capital gains tax not regular income tax.

Source: EBRI calculations. Assumes 10 percent annual rate of return and 50 percent marginal tax bracket in each year.

The next column of Table 2 shows the accumulation of the $1,000 pre tax dollars invested in a tax qualified pension plan. The difference is significant. First, the full $1,000 can be invested and the taxes payable on the initial amount can be deferred until the benefits are actually distributed. Also the interest paid to the account each year is not taxable until distribution. In the hypothetical example presented here the $1,000 pension contribution will accumulate to a value of nearly $2,600 over the ten years and will provide a post-tax distribution of $1,296.88. This is $482.43 more than the post-tax accumulation under the regular savings vehicles. In other words, 37.2 percent of the pension accumulation in this example results because of the favored tax treatment accorded pensions compared to a conventional savings program.

Under the current method of computing the tax expenditures used by the Treasury Department, the tax revenues foregone because pension contributions and interest are not treated as regular income are estimated each year. The stream of tax expenditure estimates for the hypothetical case considered here are shown in Table 2. In the first year in which the deposit is made to the pension account the tax expenditure is calculated to equal $500, thus actually exceeding in one year the total added accumulation over the ten year period that is attributable to the tax deferral on the pension accrual. This points to one potential problem in the caluclation of tax expenditures that is evaluated in more detail later. Before turning to that discussion, however, it is instructive to consider the base against which the tax expenditures are estimated.

It is clear from the example described above that the tax system clearly encourages retirement accumulations in pensions verus regular interest bearing accounts, all other things being equal. However, it is unrealistic to assume that if the pension preferences in the tax code were eliminated all expected pension contributions would end up in conventional savings vehicles. For example, the right-hand column in Table 2 shows the potential post-tax accrual the hypothetical worker described above could acquire if the initial post-tax $500 were invested in an asset that did not pay a regular dividend but rather provided its return through the increasing value of the asset itself. In this case the post-tax disposable balance from the initial $500 investment after ten years would be $1,137.50 or within $60 of the post-tax accrual under the pension option.

This does not mean that if pension contributions and interest accruals became taxable that all pension contributions would flee to accounts providing their primary returns through tax-exempt interst or capital gains. But significant portions of these accounts might flee to other activities that are favored by the tax code. For higher income individuals, in particular, this could be expected because the size of their savings over time makes it worthwhile to seek those opportunities that will minimize their tax liabilities on investment income. In this sense the estimated tax expenditures accruing to high income individuals through their pension participation are greatly exaggerated.

Middle-income individuals who have significantly lower tax rates during retirement than during their working careers receive much greater advantage from the tax treatment of pensions, on the other hand. For example in the hypothetical case considered earlier, if the marginal tax rate is 20 percentage points lower in retirement than during the working career then the disposable retirment benefits provided by the pension increase by more than $500 to $1,815.63. In this case the preferential tax treatment of the pension would account for 55 percent of the retirement benefit relative to the accumulation under a regular savings account. The elimination of preferential tax provisions for pensions will leave middle income workers with less adequate retirement benefits because they will not be able to adjust their investment portfolio in the sophisticated manner that higher income individuals can.

There is no doubt that federal tax policy has contributed to the expansion of the pension system. There is not doubt that in the short term, the tax preferences afforded retirement programs do cost the federal government some tax revenues. The conclusion that the number showing up in the annual Federal Budget is a fair representation of the pension system to federal taxpayers, however is improper.

## METHODOLOGICAL PROBLEMS IN RETIREMENT PROGRAM TAX EXPENDITURE ESTIMATES

The world is not quite as neat as the simple example discussed above and thus, the actual estimation of tax expenditures for retirement programs is quite complicated. First, Treasury estimates the foregone taxes from exemption of employer pension contributions, personal IRA contributions and the interest earned on these funds. From this foregone collections estimate Treasury subtracts the estimated tax collections on pension benefits paid in the current year. The net difference is what they currently call the estimated tax expenditure resulting from the tax treatment of retirement programs.

This calculation procedure would result in a $500 tax expenditure in the first time period in the example cited above. The computation methodology does not consider that if taxes were now collected on pension contributions and trust fund interest accruals that this would necessarily result in a reduction in the taxes to be paid in the future when benefits are disbursed.

From a purely conceptual basis the tax expenditure estimates in this instance are flawed because the estimation procedure does not even attempt to account for the significant difference in the tax collections on current benefits paid and the time discounted value of future tax collections based on current contributions under these plans. From a more practical policy analysis perspective, the estimates are further flawed because of the totally unexplained variations in estimates from year to year. Each of these problems is discussed in more detail below.

In the simple example used above it was possible to show how the tax expenditures arise and how they are measured. If the tax-expenditure concept is to have any semblance of validity in the context of pensions, then the annual measurement of these expenditures should estimate the differences in the value of a person's lifetime tax obligations that arise because part of earnings can be deferred as a pension contribution. In the aggregate, foregone revenues in the current time frame should be adjusted to account for the present value of future collections that will result because the pensions funded today will ultimately be taxed. In the current Treasury estimates of tax expenditures for retirement programs the foregone revenues are estimated on the basis of one set of individuals and the tax collections on pension benefits are estimated on a totally differrent set of individuals. This procedure upwardly biases the estimated tax expenditure for two reasons.

The first is that current workers will have higher real earnings levels over their lifetime than current beneficiaries. It is this phenomenon that raises the real level of Social Security and pension benefits alike for succeeding cohorts of retirees. As a result, the marginal tax rates that will be paid on pension benefits earned today will be higher than the marginal tax rates on benefits that are paid today. Underestimating the marginal tax rates that will apply to currently earned benefits will overestimate the magnitude of tax expenditures.

The second reason that current estimation techniques result in baised estimates of retirement program tax expenditures is that the pension system in this country is not yet mature. For example, consider the case of a new pension plan in a firm with middle age and younger workers. For several years the employer will make contributions, representing foregone tax collections in the calculation, but no benefits will be paid, and thus, there are no offsetting tax revenues collected that enter the tax expenditure calculation. If the expenditure was estimated by subtracting future discounted taxes on pensions from foregone taxes on current trust fund contributions and interest it would make no difference if there were beneficiaries or not. The maturity of the pension system would not be important if the tax expenditures were estimated as in the hypothetical example, but it is critically important given the actual method of calculation.

Table 3, based on tabulation of information that plan sponsors filed with the IRS (Form 5500) in compliance with ERISA for the 1977 plan year, indicates a clear relationship between plan age and beneficiaries in defined-benefit plans. Defined-benefit plans cover two-thirds of private plan participants and an even larger segment of the public plan members. Among other things, Form 5500 requires reporting the "effective plan date" or date the plan was set up.

It also requires that the number of active participants in the plan and the number of beneficiaries be reported. The age of the plan can be calculated from the effective plan date. As expected, most of the young plans have more workers per beneficiary than older plans do. Less than 10 percent of the plans that had been created in the previous five years reported fewer than five workers per retired beneficiary. For plans operating twenty-five years or longer, nearly 49 percent had fewer than five active participants per beneficiary. The changes in this relationship with increasing plan age are too consistent to be coincidental. At the other end of the participant/beneficiary range, the pattern is comparably consistent. More than 55 percent of plans less than five years old had twenty or more active workers per beneficiary, while less than 11 percent of the oldest plans reporting had as many as twenty participants per beneficiary.

TABLE 3.—WORKING PARTICIPANTS PER BENEFICIARY IN DEFINED BENEFIT PENSION PLANS WITH MORE THAN 100 ACTIVE PARTICIPANTS DURING 1977 BY PLAN AGE

| | Total | Plan age | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | Less than 5 years | 5–10 years | 11–15 years | 16–20 years | 21–25 years | Over 25 years | Unknown |
| Total plans (number) | 22,467 | 4,092 | 5,418 | 3,839 | 3,008 | 2,258 | 3,628 | 224 |
| Working participants Per beneficiary (Percentage of plans): | | | | | | | | |
| Two or less | 5.5 | 1.9 | 2.1 | 3.4 | 7.0 | 10.5 | 12.0 | 7.6 |
| More than 2, up to 5 | 19.8 | 7.5 | 10.2 | 17.2 | 27.9 | 31.3 | 36.9 | 21.9 |
| More than 5, up to 10 | 20.1 | 10.7 | 17.4 | 23.5 | 25.9 | 24.9 | 23.1 | 21.9 |
| More than 10, up to 20 | 15.4 | 13.1 | 19.6 | 193. | 15.7 | 12.1 | 9.4 | 12.5 |
| More than 20 | 30.0 | 55.5 | 39.7 | 26.7 | 16.9 | 14.4 | 10.8 | 26.3 |
| Unknown [1] | 9.3 | 11.3 | 10.9 | 9.9 | 6.7 | 6.7 | 7.7 | 9.8 |

[1] Includes plans with no beneficiaries reports.

Source: EBRI tabulations of 1977 plan disclosure data submitted to IRS in compliance with ERISA.

Undoubtedly many of the older plans in Table 3 with high worker/beneficiary ratios are in firms that are expanding. High worker/beneficiary ratios will continue as some plan sponsors continue to expand in the future, but such sponsors will still have increasing numbers of beneficiaries over the years. This relationship of plan age and beneficiary rates becomes particularly significant in comparison with defined-benefit plan creation data.[6] Using 1977 as the reference year, because it corresponds with the ERISA data, the universe of private defined-benefit programs grew by 218,487 plans in the previous twenty years; 32.0 percent of this growth occurred between 1973 and 1977 and 72.7 percent between 1968 and 1977. If all 28,169 tax qualified plans in existence at the end of 1955 were assumed to be defined-benefit plans, which is certainly not the case, 62.7 percent of all defined-benefit plans would have been less than ten years old at the end of 1977. The defined-benefit pension system in this country today is still quite young. As the system matures, the ratio of workers to beneficiaries will markedly decline, much as the ratio of workers to beneficiaries in the Social Security program declined during the 1950s and 1960s.[7]

---

[6] These data are spelled out in detail in Sylvester J. Schieber, Social Security: Perspectives on Preserving the System (Washington, D.C.: The Employee Benefit Research Institute, 1982) p. 52.

[7] For example, the percentage of workers participating in Social Security during 1940 was about 25 times the percentage of elderly receiving benefits in that year. As the program ma-

Continued

The ratio will decline not because of fewer covered workers, but because of more beneficiaries. The relatively small number of beneficiaries today, however, results in significant overestimates of retirement program tax expenditures.

This bias in the tax expenditure estimates will decline, to some extent, as programs mature but can never be totally resolved because of the wage growth phenomenon cited earlier.

### UNEXPLAINED VARIATIONS IN THE ESTIMATES

One of the problems with the estimates of tax exenditures arising from the special tax provisions for retirement programs is precipitous changes in the estimates from year to year that are not explained. As an example of this inconsistency Table 4 shows the tax expenditure estimates due to the tax treatment of employer sponsored plans included in the last four Federal Budgets.

TABLE 4.—FEDERAL REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" DUE TO NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS PRESENTED IN SELECTED FEDERAL BUDGETS

[Dollars in millions]

| | Fiscal year | | | | |
|---|---|---|---|---|---|
| | 1980 | 1981 | 1982 | 1983 | 1984 |
| 1981 Budget | $12,925 | $14,740 | | | |
| 1982 Budget | 19,785 | 23,605 | $27,905 | | |
| 1983 Budget | | 23,390 | 25,765 | $27,500 | |
| 1984 Budget | | | 45,280 | 49,700 | $56,560 |

Sources: Special Analysis G of the Budget of the U.S. Government for fiscal years 1981–84 (Washington, D.C.: Office of Management and Budget).

The 1981 Budget estimate of this particular tax expenditure for fiscal year 1981 was $14.7 billion. The 1982 Budget estimated the 1981 fiscal year tax expenditure for the identical category of plans at $23.6 billion—a 60 percent increase. There was absolutely no explanation in the Budget documents explaining the changed estimate from one Budget to the next. The only explanation that we have found for the 1980 and 1981 Budget differences is by Munnell who writes that the "Revised estimates employ higher, and therefore more realistic, marginal tax rate assumptions. These indicate a substantially larger tax expenditure for private plans." [8] The explanation that higher marginal rates were used to generate the 1982 Budget estimates is plausible. What is interesting is that there is absolutely no published documentation on the actual rates used to generate either the 1981 or 1982 Budget estimates. Not only does Munnell ignore this completely throughout her book on private pensions but she also fails to explain her conclusion that the higher tax rate assumptions used in the 1982 Budget estimate are "therefore more realistic." There is certainly no a priori reason to believe that any set of assumptions is more realistic than another without an analytical basis on which to evaluate them. Such analysis was not available to compare the 1981 and 1982 Budgets. There is also a lack of analysis explaining even greater discrepancies between the 1983 and 1984 Budgets. The estimated fiscal 1982 tax expenditure due to net exclusion of employer pension contributions and trust fund earnings was 75.7 percent higher in the 1984 Budget than in the 1983 Budget. The projected growth in this category of tax expenditure during fiscal 1983 was 254.8 percent higher in the 1984 Budget than in the prior Budget's estimate. Again, none of the Budget materials ore other public documents explain the revised estimates.

Through an arduous process of telephone discussions with various staff at the Treasury Department a general explaination of the revised fiscal 1983 and 1984 estimates in the 1984 Budget has been pieced together. One reason for the difference in the two Budgets is that the analyst who did the 1983 Budget estimates retired and a new analyst prepared the 1984 Budget estimate. The new analyst has been able to partially clarify the discrepency. The difference in the estimates for fiscal 1982 is

---

tured, this difference declined to less than 4 times in 1950 and then gradually moved toward and reached equality in the mid-1970's. It took Social Security about 35 years until beneficiaries made up a segment of the retired population that was comparable to the segment of the workforce that was contributing to the program.

[8] Alicia H. Munnell, The Economics of Private Pensions (Washington, D.C.: The Brookings Institution, 1982) p. 44.

$19.515 billion (i.e., $45.280–$25.765). Of this, $17.135 billion is attributable to higher estimated contributions and pension trust earnings. The remaining $2.380 billion in the higher tax expenditure estimate from the 1984 Budget is attributable to changes in the tax rate assumptions.

It appears the primary reason for the significantly (some would say astronomically) higher estimate of employer contributions and pension trust earnings is that federal civilian and state and local pension plans were included in the tax expenditure calculations for the first time. It is interesting that adding the tax expenditures attributable to public plans covering about 15 percent of the U.S. workforce can increase the tax expenditure estimate by more than two thirds. This element of the revised tax expenditure estimate can be better understood by looking at recent annual contributions to pension trusts in the various sectors.

Table 5 includes recent annual contributions to privately sponsored retirement programs, state and local plans and the federal Civil Service Retirement System. While the latter does not include all federal civilian pension costs it does capture at least 90 percent of these costs and is sufficient for this comparative analysis. What is immediately apparent is that adding in the public employer plan contributions increases the previously considered employer contribution in 1981 by 63.5 percent (i.e., $38.26/$60.26). As stated above the 1983 Budget estimate of retirement plan related tax expenditures in 1982 was $25.8 billion. The 1984 Budget tax expenditure estimate was $17.1 billion higher (or 66.3 percent) because of added trust fund contributions and interest income considered. It appears that virtually all of this adjustment can be laid directly to the inclusion of the public plans for the first time.

TABLE 5.—EMPLOYER CONTRIBUTIONS TO RETIREMENT PROGRAMS FOR SELECTED PRIVATE AND PUBLIC EMPLOYER PLANS

| | Private pension and profit sharing contributions | | State and local contributions | | Federal Civil Service Retirement contributions | | Aggregate employer contributions |
|---|---|---|---|---|---|---|---|
| | (Billions) | (Percent of total) | (Billions) | (Percent of total) | (Billions) | (Percent of total) | (Billions) |
| Year: | | | | | | | |
| 1970 | $13.0 | 66.3 | $4.6 | 23.5 | $2.0 | 10.2 | $19.6 |
| 1971 | 15.0 | 65.5 | 5.2 | 22.7 | 2.7 | 11.8 | 22.9 |
| 1972 | 17.8 | 66.2 | 5.8 | 21.6 | 3.3 | 12.3 | 26.9 |
| 1973 | 20.7 | 66.3 | 6.6 | 21.2 | 3.9 | 12.5 | 31.2 |
| 1974 | 24.2 | 65.8 | 7.8 | 21.2 | 4.8 | 13.0 | 36.8 |
| 1975 | 27.6 | 63.6 | 9.1 | 21.0 | 6.7 | 15.4 | 43.4 |
| 1976 | 33.0 | 64.0 | 10.7 | 20.7 | 7.9 | 15.3 | 51.6 |
| 1977 | 38.4 | 63.9 | 12.4 | 20.6 | 9.3 | 15.5 | 60.1 |
| 1978 | 44.0 | 64.0 | 13.7 | 19.9 | 11.0 | 16.0 | 68.7 |
| 1979 | 48.9 | 63.5 | 15.3 | 19.9 | 12.8 | 16.6 | 77.0 |
| 1980 | 54.7 | 62.3 | 17.5 | 19.9 | 15.6 | 17.8 | 87.8 |
| 1981 | 60.2 | 61.2 | 20.0 | 20.3 | 18.2 | 18.5 | 98.4 |

Sources: Private plan contributions from U.S Department of Commerce, The National Income and Product Accounts, 1948–1974 and Revised Estimates of the National Income Product Accounts (July 1982); State and local government plan contribuations from U.S. Bureau of the Census, Finances of Employee Retirement Systems of State and Local Governments, 1970–71; 1972–73; 1973–74; 1975–76; 1976–77; 1977–78; 1978–79; 1979–80; 1980–81. Table 2; Federal Civil Service Plan Contributions from U.S. Office of Personnel Management, Federal Fringe Benefit Facts 1980, 1980, table 5–1, p. 15; and unpublished data from the Office of Personnel Management.

The remaining $2.4 billion discrepancy in the 1983 and 1984 Budget estimates of retirement program tax expenditures for 1982 was attributed to changes in the tax rate assumptions. At first blush one might think that the effects of the Economic Recovery Tax Act of 1981 would be to reduce the tax rates considered for estimating these tax expenditures. Also the reductions in the contribution limits and other provisions in the Tax Equal and Fiscal Responsibility Act of 1982 should reduce the pension contributions and accruals for some individuals in the high marginal tax brackets.

Finally, the recommendation of the National Commission on Social Security Reform to tax Social Security benefits that was implemented in the Social Security legislation passed by Congress will raise marginal tax rates for many elderly pension recipients. Because the adjusted gross income thresholds at which Social Security benefits become taxable are not indexed the marginal tax rates of pension recipients should increase gradually in the future. Higher marginal tax rates among pension recipients should reduce future pension tax expenditure estimates under the current estimation methodology.

The assignment of pension contributions across individuals in the Treasury's Tax Model has not been publicly described, making it difficult to understand the reasons for or mechanics of adjusting tax rates for purposes of these calculations, however. The analyst who generated the pension tax expenditure estimates for the 1984 Budget did not know how such contributions were assigned in the model when we called to ascertain such information. Nor was he able to provide such documentation in time for development of this discussion.

One possible reason for using higher tax rate assumptions in the 1984 Budget calculations than used a year earlier is the inclusion of public workers, expecially those employed by the Federal government. "The mean annual earnings from the total civilian population employed full time in 1977 was approximately $13,849. The mean annual salary level of Federal employees covered by CSRS in April was $16,000." [9] Inclusion of federal workers with their higher than average earnings may account for the revised tax rate assumptions used to calculate the pension tax expenditures in the 1984 Budget.

## INCONSISTENCIES IN IRA AND PENSION TAX EXPENDITURE ESTIMATES

The Special Analysis G in the Federal Budget does not include separate estimates of the tax expenditures that are attributable to IRAs. The IRA related tax expenditures are embedded in a broader category of "retirement plans for self-employed and others." Table 6 shows the tax expenditure extimates for this broader category from the last four Federal Budgets. One might have expected significant increases in the tax expenditure estimates between the 1982 and 1983 Budgets, in particular, because of the passage of ERTA which roughly doubled IRA eligibility for 1982. Yet this 1982 tax expenditure estimate only increased by 11 percent between the two annual Budgets. In fact, the 1984 Budget estimate of the 1982 fiscal year tax expenditure was only 23 percent greater than the 1982 Budget and 12.5 percent greater than the 1981 estimate in the 1981 Budget.

TABLE 6.—FEDERAL REVENUE LOSS ESTIMATES FOR "TAX EXPENDITURES" DUE TO NET EXCLUSION OF CONTRIBUTIONS TO RETIREMENT PLANS FOR THE SELF-EMPLOYED AND OTHERS PRESENTED IN SELECTED FEDERAL BUDGETS

[Dollars in billions]

| | Fiscal year | | | | |
|---|---|---|---|---|---|
| | 1980 | 1981 | 1982 | 1983 | 1984 |
| 1981 Budget | $2,125 | $2,520 | | | |
| 1982 Budget | 1,925 | 2,105 | $2,305 | | |
| 1983 Budget | | 2,170 | 2,560 | $3,760 | |
| 1984 Budget | | | 2,835 | 3,755 | $4,230 |

Sources: Special Analysis G of the Budget of the U.S. Government for Fiscal Years 1981–84 (Washington, D.C.: Office of Management and Budget).

Even the 1983 Budget estimates might be understood since that Budget was prepared well before any substantive information on 1982 IRA utilization levels was available. But by the time the 1984 Budget was prepared there was evidence available suggesting that 1982 IRA utilization in response to ERTA jumped significantly over prior years. For example, EBRI released the data in Table 7 in a news release on November 19, 1982. This information was picked up quickly in both the trade press and the conventional media. This includes such newspapers as USA Today and The Washington Post. Table 7 shows that the IRA contributions during fiscal 1982 had to have been at least $21 billion.

---

[9] Final report of the Universal Social Security Coverage Study Group, The Desirability and Feasibility of Social Security Coverage for Employees of Federal, State and Local Government and Private, Nonprofit Organizations (Washington, D.C. 1980), p. 31.

### TABLE 7.—ASSETS IN INDIVIDUAL RETIREMENT ACCOUNTS, 1981–82

[Dollars in billions]

| Financial institution | Year-end 1981 | Apr. 30, 1982 | June 30, 1982 | Sept. 30, 1982 |
|---|---|---|---|---|
| Commercial banks [1] | $7.0 | $13.0 | $14.9 | $16.2 |
| Mutual savings banks [1] | 3.4 | 4.5 | 5.8 | 5.9 |
| Savings and loans [1] | [2] 9.2 | 16.3 | n.a. | n.a. |
| Mutual funds | 2.6 | 4.0 | 4.3 | 5.0 |
| Credit unions | 0.2 | 0.5 | n.a. | n.a. |
| Life insurance company | 3.3 | n.a. | n.a. | n.a. |
| Total assets | 25.7 | [3] 41.6 | [3] 45.1 | [3] 46.5 |

[1] IRA and Keogh deposits.

[2] Estimated.

[3] Baseline estimates using latest available date for each institutional category. The estimates provide a minimum total asset amount, which may under report the actual amount of total assets outstanding.

Sources: EBRI tabulations of data provided by Federal Reserve Board, National Association of Mutual Savings Banks, National Credit Union Administration, Federal Home Loan Bank Board, U.S. League of Savings Associations, Investment Company Institute and American Council of Life Insurance.

In the preparation of the 1983 Budget, the 1981 expenditure for private plans was estimated at $23.4 billion (see Table 4) on contributions of $60.2 billion (see table 5) and income on the trust funds. According to Munnell the average marginal tax rate of workers covered by a pension used to compute the pension tax expenditure was something in excess of 23 percent.[10] If the average marginal tax rate of 23 percent is applied to the minimum of $21 billion in IRA contributions then the foregone federal tax would be around $4.8 billion for fiscal 1982. Given higher rates of IRA utilization among upper income individuals this assumed marginal tax rate is likely to be quite low, understating foregone tax revenues in the current period. Few individuals are yet receiving significant IRA based annuities so the tax collections on such annuities cannot explain the discrepancy between the $4.8 billion estimated here and the $2.8 billion estimated in the 1984 Budget. The discrepancy is even harder to reconcile when the Budget's inclusion of Keogh plans is considered.

By the end of the 1982 tax year in mid-April of 1982, the same sources which provided the information for the compilation of Table 7 were reporting total IRA balances of $80 billion. That means that within the 1982 tax year new IRA contributions equaled at least $50 billion. The Treasury Department uses an average marginal tax rate of approximately 30 percent to estimate the pension tax expenditures and slightly lower rates to estimate the IRA related expenditures. Assuming a rate of 28 percent would yield an IRA tax expenditure for the 1982 tax year of at least $14 billion. Moving from a tax year period to a fiscal year period would allow some slight variation from this estimate for fiscal 1983. However, the tax year versus fiscal year discrepancy should have very little effect on the fiscal 1984 or subsequent fiscal year estimates.

## OTHER ISSUES

The abstract concept of tax expenditures has been applied to private pensions for some years now. The application of the concept has not recognized that the implementation of ERISA's minimum funding standards has excalated private employer's contribution rates in many instances. The more rapid funding of pension obligations in compliance with federal law has contributed to the growth in the tax expenditure estimates. By enhancing the "*R*etirement *I*ncome *S*ecurity," provided by pensions, the primary goal of ERISA, plan security is now being jeopardized because the resulting increase in tax expenditures heightens political pressure to reduce contribution levels. The tax expenditure concept is now being applied to state and local and federal civilian plans as well. The military retirement program is still not included in the 1984 Budget estimates of tax expenditures for employer sponsored retirement programs. The estimates does include some amount attributed to military disability benefits—but they make up only about 9 percent of the military retirement program. The military retirement program paid $31.7 billion in benefits during fiscal

---

[10] Alicia H. Munnell, The Economics of Private Pensions (Washington, D.C.: The Brookings Institution, 1982) p. 44 Munnell explains that the 23 percent rate was used to prepare the estimate for the 1981 Budget but that higher marginal rates were used in preparing the estimate for subsequent budgets.

1981 and thus is the second largest pension plan in the United States, behind the Civil Service Retirement System. In combination the federal civilian and military retirement programs cover about 5 percent of the total U.S. work force and paid retirement benefits in 1979 exceeding the benefits paid by all private pension programs.[11]

Why then, if including the federal civilian retirment program so significantly affects the tax expenditure estimates isn't the military retirement program included? One reason is that the military retirement program is totally unfunded with outstanding unfunded liabilities at the end of fiscal 1981 of $476.9 billion. Under the computation method used to estimate them no tax expenditure arises in this case. There is no contribution to or interest paid to a trust fund since none exists. The benefits paid are all taxable since the program is noncontributory.

Since the funding pattern of the plan doesn't fit the mold assumed by the computation method then the "tax expenditure" is ignored. In fact, the Civil Service plan is also largely financed on a pay-as-you-go basis. If these two retirement plans had met their normal cost contribution plus the 40 year annual amortization schedule stipulated in ERISA as the minimum funding requirement for private plans established before 1974, the total employer contribution to these two plans would have been $89.2 billion during fiscal 1981.[12] This is 48.5 percent more than the total employer contribution that went to all private plans in 1981 shown in Table 5 earlier. In other words, only one-fifth ($18.2 billion) of the federal contribution that would be required of private plans under ERISA is considered in the tax expenditure estimates when the Treasury Department estimates these for federal plans. If the estimates of tax expenditures are to be consistent, then the federal plans' tax expenditure estimates should be generated on a basis consistent with those used to estimate the private plan number. Because of the significant differences in plans across the various sectors and the role of government sponsorship or regulation, the tax expenditure estimates should be presented separately for federal, state and local, and private plans.

## RELATIONSHIP TO OTHER TAX EXPENDITURE CATEGORIES

Each of the tax expenditures is calculated on an item by item basis at the margin. That is, each is considered to be an "exceptions to the normal structure" of taxes, but is calculated as though all other exceptions are part of the normal structure for purposes of deriving the estimate. This ignores the extent to which one "exception" might be magnified because of the existence of others.

For example, consider the case of a 66 year-old single man who received $8,400 in Social Security benefits during 1982 and an additional $8,400 in pension benefits. Assume there was no other income received and no special deductions considered for calculating tax liability. This person would have adjusted gross income of $8,400 under current law. He would be eligible for a double exemption since he was over age 65 and so his taxable income would be $6,400. Schedule X of 1982 Federal Income Tax Tables indicates a tax liability of $592.

Assume as an alternative, that this man had not enjoyed the double exemptions for being over age 65 or the nontaxability of Social Security benefits. These two provisions of the tax law are considered to be "exceptions to the normal structure" because tax expenditures ar calculated for them as well. The Treasury analysts use the actual $592 in taxes paid on current benefits to estimate pension tax expenditures. However, if these other two "exceptions to the normal structure" of taxes did not exist then the man's 1982 tax liability would be $2,546.

It is clear that other "exceptions to the normal structure" give rise to large portions of tax expenditures attributed to pensions because they drastically lower marginal tax rates for the elderly. The utility of the pension tax expenditures estimate then, is extremely limited unless considered in the broader context of other tax provisions. Yet virtually no analysis of this kind is now available.

## CONCLUSIONS

A thorough analysis and discussion of the tax expenditure numbers that are published in the Budget each year is needed. Consideration of the structure of other tax code provisions that affect the estimates should be undertaken. Consideration of the life cycle structure of earnings, benefit accruals and marginal tax rates that provide a radically different distribution of the tax expenditures than cross sectional analyses is essential. Finally, inconsistencies in the actual calculation of these estimates, to say nothing of the significant methodological deficiencies in the calculation procedure must be explored.[13]

---

[11] EBRI issue brief No. 10 "Federal Pensions." (Washington, D.C.: EBRI, July 1982) p. 5.

[12] This is based on actuarial reports on the Civil Service Retirement System and military retirement program filed with the United States Congress in compliance with Public Law 95-595 for fiscal year 1981.

The current budget situation certainly warrants concern. There is no segment of the budget or tax code that should be beyond scrutiny, and that includes employee benefits. But, policy makers must understand that employee benefit incentives are crucial to the long-term welfare of broad cross sections of society. The Institute offers its assistance in evaluating the ramifications for future generations of program participants and tax payers of both current tax incentives and reform proposals.

## STATEMENT OF EDWARD J. DAVEY, EXECUTIVE DIRECTOR AND GENERAL COUNSEL, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, WASHINGTON, D.C.

Mr. DAVEY. Mr. Chairman and members of the committee:

My name is Ed Davey, executive director of the Association of Private Pension and Welfare Plans. I am accompanied today by our counsel, Ted Rhodes.

We appreciate this opportunity to appear before the committee to give our views on the tax expenditure budget. This is our third appearance before this committee over the last 2 weeks, and we are gratified to have this dialog with both you and your staff and hope that if there are any provisions relating to employee benefit matters in the proposed tax legislation that we can continue the dialog.

The private pension system is one of the most successful examples of private initiative achieving a fundamental economic and social objective. The private pension system provides retirement security for millions of past and current workers, represents an important source of capital for the development of the Nation's commerce, industry, housing, and services, and a major factor in job creation and stability.

The Nation's policy since World War II has been to encourage and foster the development of the private pension system through tax exemption on contributions and earnings.

The tax incentives have worked extremely well and by 1982 estimates are that there will be 745,000 plans holding $750 billion in assets, and with 50 million covered workers and 10 million beneficiaries.

The cost of this system in terms of a tax expenditure is estimated to be substantial. The dramatic increase in the tax expenditure for the private pension system from fiscal year 1983 to fiscal year 1984, which Dallas has pointed out, has led many in the pension community to worry that the private pension system would again become a leading candidate for any tax proposal to raise revenue.

The increased tax expenditure figures are subject to challenge, and I think Dallas' point covered that, and I won't go into that.

In any discussion, though, of these tax expenditure numbers, we should keep in mind that unlike many other tax expenditures, the tax incentives under the private pension system represent tax deferral, not tax avoidance.

---

[13] See EBRI issue brief No. 17 "Retirement Program Tax Expenditures" (Washington, D.C.: EBRI, April 1983) and EBRI statement to the Senate Finance Committee on "The Tax Treatment of Employee Benefits," June 22, 1983.

Congress may believe that changes are necessary—for example, with respect to women's equity issues, many aspects of which we testified in support of last week before the committee. However, we believe no changes should be adopted in the context of raising revenue, such as the TEFRA reduction of the maximum permissible benefits and contributions under qualified plans.

Your committee is well aware of the pressures that the social security system faces because of the changes in economic conditions and demographic projections, and we note with interest Senator Chafee's recent announcement to hold hearings on the trends and the projected life expectancy of Americans and the potential effect these trends have on retirement planning and other economic and social policies.

In conclusion, we would just say we urge this committee to avoid the temptation of using the private pension system as a quick-fix solution to solving the grave problem of our current budget deficits. There will be greater pressure placed on the private retirement system, especially in light of the social security amendments, which increased the age at which full benefits became available and have, in effect, reduced benefits.

Therefore, we must take steps now to insure the well-being of the advanced-funded private pension plans, particularly defined-benefit plans.

Thank you for your time.

The CHAIRMAN. Thank you.

Senator Long.

Senator LONG. No questions.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. I have no questions, Mr. Chairman. Thank you.

The CHAIRMAN. I have no questions, but I just want to make one comment.

I am a bit confused about your discussion of the CBO outline and its bias toward IRA's. When we asked for the study on February 15, we requested a review of how retirement benefits were distributed and the effectiveness of various types of retirement plans. We have not yet received a response with respect to this request, but I assume that CBO will address the questions raised without a preexisting bias. I mean, I understand there has been some confusion or misunderstanding by your group in some of your publications——

Mr. DAVEY. Particularly the outline.

The CHAIRMAN. In stating what our bias was, and as far as I know we don't have one.

Mr. DAVEY. Well, not with respect to your letter, with respect to the outline of CBO in response to your letter—we thought the CBO study as outlined suggested a bias in that vein.

The CHAIRMAN. But I didn't prepare the CBO study.

Mr. DAVEY. No.

The CHAIRMAN. All right.

I have no further questions.

Mr. SALISBURY. Will our full statements be entered in the record?

The CHAIRMAN. Your full statements will be a part of the record.

[The prepared statement of Ed Davey follows:]

## STATEMENT OF THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, INC.

Mr. Chairman and Members of the Committee, my name is Ed Davey, Executive Director of the Association of Private Pension and Welfare Plans, Inc. (APPWP). I am accompanied today by our counsel Ted Rhodes. The APPWP is a non-profit organization founded in 1967 with the primary goal of protecting and fostering the growth of this country's private benefit system. The Association represents some 600 organizations located across the United States. Our member firms include hundreds of plan sponsors–both large and small employers alike. Additionally, our membership includes leading organizations from every element of the employee benefits community which supports the nation's private benefit system: investment firms, banks, insurance companies, accounting firms, actuarial consulting firms, and various others associated with employee benefit plans. Collectively, APPWP's membership is involved directly with the vast majority of employee benefit plans maintained by the private sector.

We appreciate this opportunity to appear before this Committee to give our views on the "tax expenditure budget". This is our third appearance before this Committee to give our views on the "tax expenditure budget". This is our third appearance before this Committee over the last two weeks and our fourth appearance over the last two and half months. We are gratified to have this dialoque with you and your staff and hope that it will continue if there are provisions relating to employee benefit matters in proposed tax legislation.

Our testimony today concerns the tax expenditure budget as it relates to the private pension system. The private pension system is one of the most successful examples of private initiative achieving a fundamental economic and social objectives. The private pension system provides supplemental retirement security for millions of past and current workers, represents an important source of capital for the development of the nation's commerce, industry, housing, and services, and a major factor in job creation and stability.

The nation's policy since World War II has been to encourage and foster the development of the private pension system through tax exemption on contributions and earnings. The tax incentives have worked extremely well and by 1982, estimates are that there will be 745,000 plans holding $750 billion dollars in assets, and with 50 million covered workers and 10 million beneficiaries.

The cost of this system in terms of a "tax expenditure" if estimated to be substantial. The fiscal 1983 budget projects the tax expenditure for pensions plans would reach $27.5 billion dollars. This figure, however, has doubled to $56 billion dollars in the Fiscal Year 1984 budget. Considering our present and prospective grave problems of budget deficits this dramatic increase in the tax expenditure for the private pension system, has led many in the pension community to worry that the private pension system would become a leading candidate for any tax proposal to raise revenue.

The increase tax expenditure figures are subject to challenge and it this regard we commend EBRI's Issue Brief of April 1983 which describes an array of concerns with these numbers. Further, we would note that the 1984 budget also recognizes th[illegible]he private pension system may be the most efficient method of providing such benefits because the outlays expenditure figures (the direct federal budget outlay necessary to provide the same benefits) significantly exceeds the tax expenditure amount. Finally, we should keep in mind that unlike many other tax expenditures, the tax incentives under the private pension system represent tax deferral, not tax avoidance.

We believe that the private pension system provides levels of retirement income security which social security cannot deliver, performs more efficiently and effectively through employer sponsored plans that it would by individual savings or a government run system, and represents this Nation's largest source of capital. We are concerned, however, that with a number of the recent changes adopted by Congress, many plan sponsors have been discouraged from adopting or maintaining retirement plans. Congress may believe that further changes are necessary, for example issues relating to women's equity, many aspects of which we testified in support of last week before this Committee. However, we believe no changes should be adopted in the context of raising revenue, such as the TEFRA reduction of the maximum permissible benefits and contributions under qualified plans, which would eliminate incentives for establishing or maintaining retirement plans.

Your Committee is well aware of the pressures that the social security system faces because of the changes in economic conditions and demographic projections. You dealt with many of the problems facing the system with the passage of the Social Security amendments of 1983. There are, however, continuing concerns over the projected demographic trend in the next century of rising numbers of older persons qualifying for social security benefits in relation to a relatively smaller workforce that will have to bear the cost of financing their benefits. We note with interest Senator Chafee's recent announcement to hold hearings on the trends in the projected life expectancy of Americans and the potential effect of these trends on retirement planning and other economic and social policies.

The best way to meet the challenge of providing adequate retirement security for all Americans is a strong private retirement system. As I stated earlier, the current tax incentives have worked extremely well to establish a strong private retirement system. Congress since the enactment of ERISA often assisted in fostering the development of the private retirement system by providing avenues for retirement security by making available such arrangements as §401(k) plans, simplified employee plans, tax credit ESOPS and individual retirement accounts for all workers.

This trend towards the encouragement of the private system, however, suffered a severe setback when the Tax Equity and Fiscal Responsibility Act ("TEFRA") reduced the maximum permissible benefits and contributions under qualified plans and imposed additional regulatory burdens. Many fear a repeat of this type of legislation in 1983.

TEFRA especially will have an adverse impact on smaller businesses and on defined benefit plans because of the requirements of the top-heavy rules. We expect many small businesses to terminate their plans when the top-heavy requirements become effective in 1984. If this prediction is correct, there will be much larger segment of the workforce which will have to depend on their own resources to provide for an adequate retirement security, an unfortunate result for a short-term revenue gain.

Although it is unclear whether Congress will act to adopt changes in the pension area, one concern is that whatever is adopted will be bias against defined benefit plans. This concern has been generated for a response to a letter from Senator Dole requesting the Congressional Budget Office to review the tax incentives for retirement savings. In response to this request the CBO has prepared an outline which clearly favors the approach of expanding the development of individual retirement accounts and curtailing the use of defined benefit plans. This has lead many, including Senator Jacob Javits, one of the principal authors of ERISA, who testified on the subject before the Subcommittee on Labor, Committee on Labor and Human Resources on May 24, 1983, to be concerned with the outcome of legislative activity in this area.

We are not opposed to the concept of individual retirement accounts, in fact, we played a major role in the development of the 1981 legislation which granted across-the-board IRA deductions. We believe, however, that the IRA represents a vital supplement to retirement security and cannot serve as a replacement for that retirement security. Moreover, we believe that defined benefit and defined contribution plans each play an important but substantially different role in the worker's retirement security.

Of the two types of plans, the defined benefit plan, with the safeguards like funding standards and termination insurance, is most likely to provide adequate retirement security. A defined benefit plan places the risk of providing the promised benefit on the employer. A defined contribution plan, on the other hand, avoids the pension plans inherent commitment to adequate retirement income because the risk of plan investment is shifted to the employee.

We strongly believe that any attempted shift away from defined benefit plans will result in substantial lessening of the retirement security of the "baby boom generation." It is this generation of individuals who are dependent on satisfying their retirement needs through participation in the private pension system rather than the social security system. The problem with relying solely on defined contribution plans or IRA's to fill this need is the disparity of treatment under such plans depending on the state of the financial and stock markets at the time of retirement. For instance, an individual retiring today would have substantially greater retirement security than a similarly situated individual who retired in 1981, because of the upsurge of the stock market. Defined benefit plans, on the other hand, provide the retiree with an adequate amount of retirement income, guaranteed by the federally sponsored termination insurance system.

In conclusion, we urge this Committee to avoid the temptation of using the private pension system as a "quick-fix" solution to solving the grave problems of our current budget deficits. There will be greater pressure placed on the private retirement system especially in light of the Social Security amendments which increased the age at which full benefits became available and have, in effect, reduced benefits.

Therefore, we must take steps now to ensure the well-being of the advance-funded, private pension plans, particularly defined benefit plans.

The CHAIRMAN. We will be in recess until 3 o'clock, at which time we will mark up revenue-sharing and approve three ITC nominees and the health care for the unemployed.

[Whereupon, at 11:48 a.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

## STATEMENT BY SENATOR DAN QUAYLE, HEARINGS ON TAX EXPENDITURES, U.S. SENATE, COMMITTEE ON FINANCE

Mr. Chairman, I am grateful for this opportunity to present my views to this Committee on the important subject of tax expenditures.

In my opinion, the profusion of tax expenditures in the U.S. tax code operates to induce Americans--both individuals and businesses--to spend and consume, rather than to save and invest. Through the various enacted tax expenditures, the Federal Government essentially subsidizes the tax code's preferred modes of spending and consumption. Federal policy in this area has thus contributed to our recent low levels of investment and low levels of productivity growth.

The result of the array of tax expenditures in the U.S. tax code has been a basic imbalance in U.S. economic policy: individuals and businesses are treated unevenly; different individuals with similar levels of income end up paying very different levels of tax; different businesses with similar profit margins also end up with very different tax burdens. Individuals and businesses, because of the operation of the tax code, have placed their resources into tax shelters that have diverted funds from productive investment. All of this has resulted in inefficiency in economic decision-making and very low rates of productivity growth.

We are today experiencing a major technological transformation. We are going from a predominantly manufacturing base to an information era. New industries based on high technologies, such as data processing and biogenetic engineering are emerging, and the opportunities they present raise questions about the proper role of government in economic affairs.

I believe that the time has come to reevaluate the overall effect of our current Federal tax policies. If the economy is transforming itself, government should not add to the burdens and difficulties, but should foster and facilitate necessary change. Finding a rational and efficient tax policy that promotes modernization is the major challenge facing American government today.

My statement today addresses the impact of current tax expenditures on our economic and productivity growth. It also presents a brief description of my own proposal, the SELF-tax plan of 1983. I ask that this statement be printed in the record.

## Restoring Sustained Productivity Growth: the Economic Challenge

The 1970's saw the decline of U.S. productivity growth rates to the lowest levels since the end of World War II.[1] While the causes of productivity growth and decline are complex and varied they have clearly been substantially influenced by Federal tax policies.

Productivity growth results from the decisions of individuals and business enterprises concerning saving and investment. Other individual decisions that affect productivity include education, career changes, technological training, and retirement. Government policies have a substantial impact on these individual choices.

For example, Federal government policies in the 1970's resulted in great increases in government spending and deficits at a time when the country was going through a period of rapid inflation; this brought about an acceleration of inflation along with high interest rates. High interest rates made it difficult for business to borrow to improve plant and equipment; over the decade many businesses fell into decline compared to foreign competitors. This, of course, led to high unemployment, layoffs and recession. High inflation had similar effects: saving declines and consumption increases during inflationary periods, because individuals and businesses fear their income will erode if it is placed into long-term savings. This has the effect of reducing the total amount of resources available in the economy for investment. The effect is to reduce the potential for technological modernization and expansion in industry and leads to low levels of productivity growth.

Low-levels of saving and investment has been a persistent problem in the U.S. and will be very difficult to overcome without major changes in government policy. The Federal government has been in deficit every year since 1969, and deficits have grown rapidly both in dollar terms and as a percent of GNP. High levels of Government borrowing due to this persistent deficit again are threatening to crowd out private investment (see Table 1).

## Table 1

### Projected Deficits, FY1983 - FY1986 and Estimated Federal Deficit Compared to Net Private Savings

| Year | Projected Deficit* | Deficit as Share of GNP (percent | Federal Deficit in Relation to Net Private Savings (percent) |
|---|---|---|---|
| FY83 | 203.10 | 6.4 | 98.1 |
| FY84 | 169.90 | 4.9 | 76.9 |
| FY85 | 156.25 | 4.0 | 64.8 |
| FY86 | 127.15 | 3.1 | 48.7 |

Source: Conference Report, First Concurrent Resolution on the Budget for FY 1984 (June 20, 1983).

* Deficit excludes amounts reserved pursuant to Section 2 of the Conference Substitute, Fiscal Year 1984.

The major determinants of productivity--the quality of the labor force, the accumulation of capital and the pace of technological change--are closely interconnected. Unemployment policies, for example, when they do not provide incentives for the acquisition of new skills by the unemployed (as is currently the case in the U.S.), contribute to the persistence of low productivity. Economic slack (given current tax policies) also undermines the incentive to invest in new plants and equipment, and to develop and adopt new technology. Inflation, which in recent years has accompanied our high levels of government deficit, increases business uncertainty, thus diminishing innovation and investment.

Many specific U.S. policies and regulations foster inflation, high unemployment, and low productivity growth. For example, tax policies encourage consumption by providing credit against interest accrued on expenses. This, of course, encourages individuals to spend and incur debts, leading directly to inflationary pressures. Also, because buying power has been eroded by inflation, individuals have attempted to protect their resources by investing in tax-protected investments--durable goods and real property--as a hedge against inflation. These are comparatively unproductive investments, which produce fewer jobs than would investments in business plant and equipment. This national tendency to consume rather than to save has resulted in a national average ratio of savings to disposable income below that of any other major industrial nation--less than one-fourth the averages of Italy and Japan; only one-third that of France, Germany and the United Kingdom; and, less than half that of Canada. (see Table 2).

Table 2
Ratios of Savings to Disposable Personal Income: And Ratios of Gross Fixed Capital to GNP, Selected Nations, 1970-79

(In Percent)

| | United States | France | Federal Republic of Germany | Italy | Nether-lands | United King-dom | Japan | Canada |
|---|---|---|---|---|---|---|---|---|
| 1. Ratio of savings to disposal personal income: | | | | | | | | |
| 1970 . . . . . . . . | 7.4 | 16.7 | 14.6 | 18.8 | 14.0 | 9.0 | 18.1 | 5.3 |
| 1971 . . . . . . . . | 7.7 | 16.8 | 14.3 | 20.6 | 15.0 | 8.5 | 17.5 | 5.9 |
| 1972 . . . . . . . . | 6.2 | 16.8 | 15.5 | 21.4 | 15.4 | 10.4 | 18.0 | 7.4 |
| 1973 . . . . . . . . | 7.8 | 17.3 | 14.9 | 20.9 | 16.5 | 11.9 | 20.5 | 9.1 |
| 1974 . . . . . . . . | 7.3 | 17.4 | 16.1 | 19.2 | 16.6 | 14.4 | 23.7 | 9.9 |
| 1975 . . . . . . . . | 7.7 | 18.6 | 16.4 | 23.0 | 14.5 | 14.0 | 22.5 | 10.9 |
| 1976 . . . . . . . . | 5.8 | 16.4 | 14.7 | 21.8 | 14.6 | 13.4 | 22.4 | 10.2 |
| 1977 . . . . . . . . | 5.0 | 17.3 | 13.7 | 23.1 | 12.8 | 13.3 | 21.1 | 10.0 |
| 1978 . . . . . . . . | 4.9 | 18.2 | 13.8 | NA | 12.9 | 14.1 | 20.1 | 10.4 |
| 1979 . . . . . . . . | 4.5 | 17.1 | 14.6 | NA | NA | 15.7 | NA | 10.3 |
| 2. Ratio of gross fixed capital formation to GNP | | | | | | | | |
| 1969 . . . . . . . | 18.1 | 25.4 | 24.1 | 20.1 | 24.3 | 18.3 | 35.1 | 21.0 |
| 1970 . . . . . . . | 17.3 | 23.3 | 25.6 | 23.1 | 25.6 | 18.4 | 35.4 | 21.0 |
| 1971 . . . . . . . | 17.7 | 23.6 | 26.4 | 20.2 | 25.7 | 18.3 | 34.2 | 22.0 |
| 1972 . . . . . . . | 18.3 | 23.6 | 25.9 | 19.7 | 23.6 | 18.2 | 34.0 | 21.9 |
| 1973 . . . . . . . | 18.4 | 23.8 | 24.5 | 21.2 | 22.8 | 19.1 | 36.6 | 22.5 |
| 1974 | 17.8 | 24.5 | 21.9 | 22.5 | 21.6 | 20.3 | 34.8 | 23.2 |
| 1975 . . . . . . . | 16.3 | 23.2 | 20.7 | 20.6 | 20.8 | 19.6 | 32.2 | 24.2 |
| 1976 . . . . . . . | 16.4 | 23.3 | 20.6 | 20.1 | 19.2 | 18.9 | 31.0 | 23.5 |
| 1977 . . . . . . . | 17.4 | 22.2 | 20.8 | 19.7 | 20.9 | 18.3 | 30.1 | 23.0 |
| 1978 . . . . . . . | 18.1 | 21.4 | 21.5 | 18.8 | 21.2 | 18.0 | 30.2 | 22.6 |
| 1979 . . . . . . . | 17.9 | NA | 22.9 | NA | NA | 17.5 | 31.7 | 22.7 |

Basic data U.S. Department of Commerce, International Administration, "Institutional Economic Indicators," June 1979 and June 1980

While the U.S. labor force has been growing, the country's capital stock has been expanding at a reduced rate. From 1947 to 1973, capital stock grew at an average annual rate of 4.0 percent. Since 1973, however, this average has been less than 2.5 percent. Net of depreciation, capital per employed individual rose at an average annual rate of about 2.0 percent from 1948 until 1969, but fell to about 1.2 percent thereafter.

A high capital-labor ratio figures significantly into an economy's productivity growth rate regardless of what measure is used. Since it is largely through new plant and equipment that more advanced technologies are introduced into the production process, the absence of increases in capital inputs result in diminished marginal returns on each additional input of labor employed. One feature of those countries with high productivity growth rates is the resulting concomitant increases in capital-labor ratios. (See Table 3).

## Inefficiencies Caused by the Current Federal Tax Structure

### A. Consumption Bias in the Individual Income Tax Code

The U. S. tax structure is a major factor inducing Americans, both individuals and businesses, to consume in the short-term rather than to save. Americans, as already noted, rather than putting their resources into financial investments that could lead to business expansion and modernization, have instead put much of their investments

### Table 3
### Average Annual Growth in Gross Domestic Products Per Employed Person in Leading Industrial Countries, 1960-79

(Percent change per year)

| Country | 1960 to 1979[1] | 1960 to 1970 | 1970 to 1979[1] |
|---|---|---|---|
| United States | 1.5 | 2.0 | 1.1 |
| Belgium | 3.7 | 4.2 | 3.2 |
| Canada | 1.9 | 2.3 | 1.3 |
| France | 4.2 | 4.9 | 3.4 |
| Germany | 3.9 | 4.4 | 3.4 |
| Italy | 4.6 | 6.4 | 2.6 |
| Japan | 7.1 | 9.5 | 4.5 |
| Netherlands | 3.6 | 4.0 | 3.3 |
| United Kingdom | 2.4 | 2.7 | 2.0 |

[1] Data for 1979 are preliminary.

into housing and other durable goods. This is largely due to the favorable tax treatment of housing and to a lesser extent, durable goods, provided by the U.S. tax code.

Under current tax laws, capital gains on owner-occupied housing is taxed at a relatively low rate, while income from financial assets, including capital goods that underlie them, are all taxed at higher rates (because our system in effect taxes these financial assets twice--at the corporation and at the individual levels). Rate of return on alternative assets after allowing for inflation and taxes are important in determining the ways in which individuals save.

People prefer more income to less, and thus they prefer higher yields (adjusted for risk) to lower yields. For the past ten years or so, investment in housing has provided one of the highest rates of return available to most savers. In this period people with assets put their resources into real estate because alternative investments could not provide as high a return: the home mortgage and local property tax deductions in effect provided a subsidy from the Federal government to the home owner, while inflation drove the resale value of houses higher. People who bought and sold houses in the 1970's could shelter their assets from inflation much better than people who invested in stocks, bonds and bank accounts, because these latter alternatives declined in value over the same period and were not supported by such generous government tax subsidies.

Some recent changes to the tax system, such as the introduction of accelerated depreciation and the expansion of Individual Retirement Accounts (IRAs) have helped to ease the individual's tax burden slightly. One provision of the Windfall Profits Tax Act of 1980 increased the interest income deductible to $200. Many experts agree, however, that such a small exclusion will be unlikely to affect aggregate levels of savings.

## The Growth of Tax Expenditures and Complexity in the Tax Code

In an effort to provide some shelter from excessive taxation of productive assets, we have created many special preferences, known as "tax expenditures." For example, we permit numerous exclusions, which reduce taxable income (an example of this is the exclusion of income earned abroad by U.S. citizens). We also have preferential tax rates which reduce taxes by applying lower rates to part or all of a taxpayer's income (an example of this is the reduced rates on the first $100,000 of corporate income). We have enacted credits which are subtracted from taxes as ordinarily computed (an example is the investment tax credit for rehabilitation of structures). Finally, we allow some deferrals of tax payments, either by delaying recognition of income or by allowing current year deductions to be attributable to a future year (an example of this is the DISC--the deferral of income tax on domestic international sales corporations).

Under current law, tax expenditures result in great losses of revenue to the Federal government. Estimated lost revenue in 1983 due to tax expenditures will be almost $300 billion. This is over 50 percent greater than the currently estimated Federal deficit. Yet it must be pointed out every tax deduction and credit has great merit on its own. From a political point of view it becomes exceedingly difficult to remove tax preferences on an item-by-item basis.

The consequence of all these additions to the tax code has been the creation of an extremely complex and administratively burdensome tax system. Some experts have estimated that approximately half of all government-created paperwork results from the requirements of tax laws, resulting in an estimated expenditure of 650 million man hours annually. The system increasingly lacks the cooperation of the taxpayers. The Internal Revenue Service (IRS) has estimated that as much as 15 percent of all income now goes unreported. This is perhaps the highest percentage in the history of the Service. To put that percentage into dollars, consider that the income tax compliance gap is estimated to have grown from $21 billion in 1973 to $76 billion to 1981. It is now estimated to be as high as $100 billion.

The current U.S. tax system also imposes a tremendous regulatory cost. At present, IRS maintains a workforce of 50 attorneys who spend about 65 percent of their time writing regulations authorized by Congress. Today, those IRS regulations, as contained in Title 26 of the United States Code, occupy nearly 10,000 pages. The complex nature of our tax system has the effect of requiring more, rather than fewer, regulations and the need for increased enforcement will ultimately require expansion of existing regulations. Already a clear majority of those Americans who itemize their individual income tax returns have their forms filled out by professionals. The current system can only add to further noncompliance and revenue loss.

For many individuals the loopholes in the present tax system effectively redistribute the tax burden and alter the actual effect of the published progressive tax rates. By allowing the exclusion of substantial portions of income from the tax base, rates imposed on the remainder must be kept high to maintain Federal revenues.

For example, in 1961 only 10 percent of U.S tax returns had marginal tax rate of other than 20 to 22 percent. In that year we had a nearly flat rather than progressive schedule of tax rates.[2] While published tax rate schedules today are much more progressive than they were in 1961 (they now range from zero to 50 percent), the profusion of tax exemptions we have enacted have created numerous "winners and losers."

Average tax rates, as a percent of personal income, have increased in the United States, despite the passage in 1964 and 1981 of laws which substantially lowered maximum tax rates (from 91 to 70 percent in 1964; from 70 to 50 percent in 1981).[3] Between 1951 and 1981 the average tax rate, as a percentage of personal income, rose from 9.2 percent in 1951 to 12.1 percent in 1981.

Because of the complexity of the tax laws, equity has been sacrificed; taxpayers with the same income may pay very different rates of tax depending on their eligibility for the different tax preferences. Tax expenditures have rendered the otherwise progressive tax system far less progressive, partly because tax loopholes are the most widely used by taxpayers in high income brackets to reduce their tax burden. Also, these are the taxpayers who are most able to afford tax specialists to help them take advantage of tax preferences.

## B. Effects of Current Federal Tax Laws on Business

The effect of current tax laws on business has been similar to individuals: The host of tax preferences which have been added to the tax code over the years create a wide disparity of effective tax rates across industries. Table 4 summarizes the major tax preferences, and Table 5 illustrates the effects of these tax preferences on the effective tax rates by industry.

As can be seen from Table 5, under current (1981) law, effective tax rates range from -12.6 percent on commercial banks to 39.7 percent on apparel companies. This dispersion of 52.3 percentage points in the tax burden imposed on different industries is far from the neutral corporate tax which would minimize the economic inefficiency of the tax system.

Each of the tax expenditures in the current law were added to meet a specific felt national need at the time of enactment. Unfortunately, the net result of all of these preferences taken together has been to reduce the effective tax rates imposed upon corporations in a haphazard way. Some of these tax expenditures

## TABLE 4
## IMPORTANT TAX PREFERENCES FOR SELECTED INDUSTRY GROUPINGS, 1981
(Preferences in Descending Order of Importance)

Aerospace Companies
Long-term contracts, investment tax credit, DISC

Apparel Companies
Investment tax credit, possessions corporations, accelerated depreciation

Automotive Companies
Investment tax credit, accelerated depreciation, DISC

Beverage Companies
Investment tax credit, accelerated depreciation, intangible drilling costs

Chemical Companies
Accelerated depreciation, investment tax credit, intangible drilling costs

Commercial Banks
Tax-exempt income, accelerated depreciation, investment tax credit

Diversified Service Industries
Investment tax credit, accelerated depreciation, long-term contracts

Electronics and Appliance Companies
Investment tax credit, accelerated depreciation, DISC

Food Processors
Investment tax credit, accelerated depreciation, DISC

Glass, Concrete, Abrasives and Gypsum Companies
Accelerated depreciation, investment tax credit, depletion

Industrial and Farm Equipment Companies
Investment tax credit, accelerated depreciation, DISC

Instrument Companies
Investment tax credit, accelerated depreciation, possessions corporations

Life Insurance Companies (Stock)
Special insurance deductions, tax-exempt income, deferred acquisitions costs

Metal Manufacturing Companies
Investment tax credit, accelerated depreciation, depletion

Metal Products Companies
Investment tax credit, accelerated depreciation, long-term contracts

Mining and Crude Oil Production Companies
Accelerated depreciation, investment tax credit, intangible drilling costs

Musical Instruments, Toy, and Sporting Goods Companies
Investment tax credit, accelerated depreciation, long-term contracts

Office Equipment Companies
Investment tax credit, DISC, accelerated depreciation

Oil and Refining Companies
Accelerated depreciation, investment tax credit, intangible drilling costs

Paper, Fiber, and Wood Products Companies
Accelerated depreciation, investment tax credit, capital gains

Pharmaceutical Companies
Possessions corporations, investment credit, accelerated depreciation

Publishing and Printing Companies
Investment tax credit, accelerated depreciation, capital gains

Food Retailers
Investment tax credit, accelerated depreciation, capital gains

Non-Food Retailers
Accelerated depreciation, investment tax credit, tax-exempt income

Rubber, Plastics, and Leather Products Companies
Investment tax credit, accelerated depreciation, long-term contracts

Shipbuilding, Railroad, and Transportation Equipment Companies
Accelerated depreciation, investment tax credit, long-term contracts

Soap and Cosmetics Companies
Accelerated depreciation, investment tax credit, possession corporations

Textile and Vinyl Flooring Companies
Investment tax credit, accelerated depreciation, depletion

Tobacco Companies
Accelerated depreciation, investment tax credit, tax-exempt income

Transportation Companies
Accelerated depreciation, investment tax credit, capital gains

Utilities
Capitalized interest and construction costs, investment tax credit, accelerated depreciation

SOURCE: Congressional Budget Office

### TABLE 5
### EFFECTIVE CORPORATE TAX RATES BY INDUSTRY - 1981
(Percentage of Net Income Paid in Tax --
U.S. Rate on U.S. Income)

| Industry | Tax Rate (Percent) |
|---|---|
| Commercial Banks | -12.6 |
| Transportation Companies | -4.8 |
| Shipbuilding, Railroad, and Transportation Equipment Companies | -1.2 |
| Paper, Fiber, and Wood Products Companies | 4.0 |
| Mining and Crude Oil Production Companies | 9.4 |
| Metal Manufacturing Companies | 10.1 |
| Utilities | 11.5 |
| Life Insurance Companies (Stock) | 13.0 |
| Aerospace Companies | 13.5 |
| Chemical Companies | 13.6 |
| Automotive Companies | 19.1 |
| Glass, Concrete, Abrasives, and Gypsum Companies | 19.8 |
| AVERAGE RATE FOR ALL INDUSTRIES | 20.5 |
| Oil and Refining Companies | 21.4 |
| Non-Food Retailers | 22.0 |
| Rubber, Plastics, and Leather Products Companies | 23.4 |
| Metal Products Companies | 24.1 |
| Office Equipment Companies | 26.7 |
| Instrument Companies | 26.8 |
| Diversified Service Industries | 27.8 |
| Pharmaceutical Companies | 28.5 |
| Beverage Companies | 28.6 |
| Industrial and Farm Equipment Companies | 28.8 |
| Electronics and Appliance Companies | 29.3 |
| Food Retailers | 30.8 |
| Tobacco Companies | 31.4 |
| Textiles and Vinyl Flooring Companies | 31.9 |
| Food Processors | 33.6 |
| Musical Instruments, Toy, and Sporting Goods Companies | 34.5 |
| Publishing and Printing Companies | 36.3 |
| Soap and Cosmetics Companies | 39.4 |
| Apparel Companies | 39.7 |

SOURCE: Tax Notes

Effective tax rates are based on a sample of firms and therefore are subject to sampling variation.

apply only to particular industries such as the expensing and depletion provisions for mineral extraction industries. Other tax expenditures apply generally, such as the investment tax credit and accelerated depreciation, but even these provisions differentially favor those industries that happen to use relatively more depreciable capital.

Capital responds to this preferential tax treatment by flowing to the most tax-favored industries, where the after-tax rates of return are greater. This flow continues until after-tax returns in the tax-preferred industries are bid down to equality with these industries that are more heavily taxed. The result is that the Nation's capital stock is misallocated; there is too much investment in the tax-favored industries, and not enough in the others. The value of our total income is therefore reduced; we would produce more output according to society's valuation if there were no tax preferences, and tax rates were equal across industries: In that circumstance, capital would be reallocated until pre-tax returns were equal, and so output in society's view would be maximized.

The problems with the current tax system, and the corresponding benefits from streamlining the law, show up in different ways. Corporate tax expenditures reduce the amount of revenue collected at any given statutory tax rate, and therefore force tax rates up. That means that undertaking any non-taxed preferred activity is less profitabl and, therefore, in all likelihood less activity will take place.

For business, as for individuals, the need for higher tax rates imposed by the tax expenditures creates a vicious cycle. The higher the statutory tax rates, the greater is the incentive to take advantage of preferences and shelters. Over time, there is ever-increasing pressure for the creation of new tax expenditures. Eliminating most tax preferences and reducing the tax rates both cut this vicious cycle.

Finally, the present tax system, by allowing interest expense deductibility and the double taxation of dividends, creates a bias towards debt versus equity finance. This increases the firm's exposure to the risks of bankruptcy from which society may suffer major economic loss.

In sum, the current U.S. tax structure has resulted in a growing disrespect by taxpayers for the whole system. In addition to major revenue losses to the Federal government, there has been increased tax avoidance and the growth of inefficient and non-economic activities by both individuals and businesses--all motivated by a desire to avoid the presently high official marginal rates of taxation.

## Rebuilding Our Capacity for Economic Growth: U.S. Tax Policies for the 1980's

A major priority for the U.S. government in the 1980's must be to reverse the push of present policies to waste and inefficiency through the promotion of spending and consumption. We must consciously begin to foster saving, investment and real economic growth. In an effort to provide a basis for discussion of simplification of the tax code this year I introduced in the Senate S. 1040, the SELF-tax Plan Act of 1983.

## The SELF-Tax Plan of 1983

As I said last year, I believe we need to reexamine the fundamental structure of our tax system. We must reestablish SELF as the overriding principles in taxation: simplicity, efficiency, low tax rates, and fairness. These principles entail the following:

People should be able to understand the basic requirements of the tax law and to file their returns by themselves, without the need for professional assistance.

All income should be taxed as equally as possible, with some consideration given to ability to pay. People who earn the same income should pay the same tax.

The poor should not be taxed at all, and we should be careful to establish this standard fairly generously.

Specific preferences and subsidies should be removed from the tax code; economic policy should be addressed directly and not through incomprehensible tax manipulations.

What I am advocating is a return to a relatively simplified, low-rate, progressive tax structure. My plan, which would raise roughly the same amount of revenue as under current law, would establish low rate tax schedules while broadening the tax base. Under the SELF-tax, almost all special tax exemptions would be eliminated from the internal revenue code.

Under the SELF-tax, income which would be subject to tax would include present law adjusted gross income, income from capital gains and capital losses, government transfer payments, half of social security benefits, employer benefits currently not taxed, tax exempt interest, and income from other tax preferences. Social security and other pension contributions would, however, not be taxed twice.

In order that the poor should not be subject to tax I would establish a relatively high zero-bracket. Currently, the officially defined poverty level is about $9,000 per year for a family of four; the value of transfer payments received by the same size family is now estimated to be equal to about $5,000 per year. Under the SELF-tax, a married couple filing jointly would not have to pay tax on any income up to $10,000 and would, in addition, receive a personal exemption of $1,000 per person. A family of four could thus earn $14,000 free of tax under this plan; no poor family would pay any tax.

I believe that wealthier taxpayers should pay somewhat higher rates of tax than average or lower income taxpayers. I also believe that the marriage penalty should be reduced as far as possible, but without creating a large "singles" bonus. After considerable study and analysis, the SELF-Tax Plan of 1983 provides for the following tax rate schedules for individuals:

(See Table 6)

Table 6

SELF-Tax Plan of 1983: Tax Schedules

| If taxable income is: | The tax is: |
|---|---|
| Schedule I. Single taxpayers who do not qualify for rates in Schedules II and III: | |
| Not over $6,000 | No tax |
| Over $6,000 But not over $16,000 | Zero plus 14 percent of excess over $6,000 |
| Over $16,000 But not over $40,000 | $1,400 plus 21.0 percent of excess over $16,000 |
| Over $40,000 | $6,440 plus 28.0 percent of excess over $40,000 |
| Schedule II. (A) Married Taxpayers filing joint returns,<br>(B) Certain widows and widowers: | |
| Over $10,000 | No tax |
| Over $10,000 but not over $26,000 | Zero plus 14 percent of excess over $10,000 |
| Over $26,000 but not over $60,000 | $2,240 plus 21 percent of excess over $26,000 |
| Over $60,000 | $9,380 plus 28 percent of excess over $60,000 |
| Schedule III. Unmarried (or legally separated) taxpayers who qualify as heads of household: | |
| Over $6,000 | No tax |
| Over $6,000 but not over $19,000 | Zero plus 14 percent of excess over $6,000 |
| Over $19,000 but not over $50,000 | $1,820 plus 21 percent of excess over $19,000 |
| Over $50,000 | $8,330 plus 28 percent of excess over $50,000 |
| Schedule IV. Married individuals filing separate returns: | |
| Over $5,000 | No tax |
| Over $5,000 but not over $13,000 | Zero plus 14 percent of excess over $5,000 |
| Not over $13,000 but not over $30,000 | $1,120 plus 21 percent of excess over $13,000 |
| Over $30,000 | $4,690 plus 28 percent of excess over $30,000 |
| Schedule V. Estate and trust: | |
| Over $8,000 | 14 Percent of taxable income |
| Over $8,000 but not over $25,000 | $1,120 plus 21 percent of excess over $8,000 |
| Over $25,000 | $4,690 plus 28 percent of excess over $25,000. |

As can be seen from the Table, the SELF-Tax has four tax brackets. For single individuals, income under $6,000 would not be taxed; between $6,000 and $16,000 the tax would be 14%; between $16,000 and $40,000 the tax would be 21%; and over $40,000 the tax rate would be 28%. For married taxpayers filing jointly, income below $10,000 would not be taxed; between $10,000 and $26,000 the rate would be 14%; between $26,000 and $60,000 the tax rate would be 21% and over $60,000 the tax rate would be 28%. No taxpayer would pay a higher rate than 28 per cent.

The SELF-Tax Plan of 1983 also provides for a personal exemption of $1,000 per person in order to be equitable to families incurring the costs of raising children and supporting other dependents who have no income. I believe that these provisions plus the SELF-Tax's proposed tax schedules reduce the current marriage penalty, recognize the differential costs of single compared to married taxpayers, and generally establish a system in which single and married taxpayers are treated fairly and even-handedly.

The SELF-Tax Plan of 1983 would create numerous "winners" and "losers" compared to current law. The comparison in total tax increases and decreases received by income group is shown in Table 7 .

Table 7

TAX DECREASES AND INCREASES: THE SELF-TAX VERSUS 1984 CURRENT LAW

| Expanded income (actual) | Tax Decreases | | | Tax Increases | | | Net | Percent |
|---|---|---|---|---|---|---|---|---|
| | Returns (thousands) | Amount (millions) | Average (actual) | Returns (thousands) | Amount (millions) | Average (actual) | Tax change (millions) | Total distribution |
| Less than $10,000 | 13,930 | −$2,668 | −$192 | 9,742 | $4,749 | $487 | $2,081 | −28.1 |
| $10,000, but less than $20,000 | 17,915 | −7,151 | −399 | 6,497 | 4,013 | 618 | −3,139 | 42.3 |
| $20,000, but less than $30,000 | 11,653 | −10,105 | −867 | 5,532 | 5,233 | 946 | −4,872 | 65.7 |
| $30,000, but less than $40,000 | 6,249 | −8,357 | −1,337 | 3,077 | 4,315 | 1,403 | −4,042 | 54.5 |
| $40,000, but less than $50,000 | 2,731 | −4,957 | −1,815 | 1,375 | 3,107 | 2,260 | −1,849 | 24.9 |
| $50,000, but less than $75,000 | 1,682 | −4,304 | −2,558 | 1,050 | 4,141 | 3,944 | −163 | 2.2 |
| $75,000, but less than $100,000 | 399 | −1,740 | −4,364 | 337 | 2,346 | 6,960 | 606 | −8.2 |
| $100,000, but less than $200,000 | 342 | −3,022 | −8,827 | 281 | 3,938 | 14,012 | 917 | −12.4 |
| $200,000 | 76 | −2,877 | −37,618 | 80 | 5,925 | 73,601 | 3,048 | −41.1 |
| Total | 54,977 | −45,179 | −822 | 27,971 | 37,766 | 1,350 | −7,413 | 100.0 |

Table 7 shows that under the SELF-Tax, there are winners and losers in all income classes when compared to present law. For individuals in the less than $10,000 category, almost 14 million returns would have a tax decrease, while 9.7 million would have a tax increase. Many taxpayers who in this category would suffer a tax increase under the SELF-tax, would do so because of a loss of tax shelters under the proposal. Middle income taxpayers generally fare better under the SELF-Tax than under current law: for example, in the $10,000-20,000 category, almost 18 million returns show a tax decrease while nearly 6.5 million show an increase. While the highest income groups also show numerous winners and losers, their proportions are much closer: for example, in the above $200,000 category, 76,000 returns show a decrease while 80,000 returns show an increase. Income groups earning over $100,000 per year would pay higher taxes under the SELF-tax than under current law.

Another way of comparing the effects of the SELF-tax Plan to current law is to compare average income tax liabilities for those who itemize to those who do not itemize by income category. This is presented in Table 8.

Table 8

## DISTRIBUTION OF AVERAGE INCOME TAX LIABILITIES: CURRENT LAW, THE SELF-TAX AND TAX CHANGE BY EXPANDED INCOME FOR ALL RETURNS

[1981 levels of income]

| Expanded income | Current (1984) law |  | Self-tax plan of 1983 |  | Tax change |  |  |
|---|---|---|---|---|---|---|---|
|  | Returns (units) | Average tax liability | Returns (units) | Average tax liability | Returns (units) | Average tax liability | Percent change |
| Less than $10,000 | 3,272,183 | $206 | 2,209,425 | $494 | 3,524,451 | $113 | 54.8 |
| $10,000, but less than $20,000 | 6,995,807 | 1,201 | 6,653,123 | 1,344 | 7,198,189 | 75 | 6.2 |
| $20,000, but less than $30,000 | 10,038,044 | 2,496 | 10,104,951 | 2,427 | 10,128,456 | −52 | −2.1 |
| $30,000, but less than $40,000 | 7,238,387 | 4,061 | 7,286,618 | 3,795 | 7,298,665 | −238 | −5.9 |
| $40,000, but less than $50,000 | 3,589,204 | 6,084 | 3,602,573 | 5,740 | 3,603,803 | −321 | −5.3 |
| $50,000, but less than $75,000 | 2,520,023 | 9,629 | 2,520,307 | 9,579 | 2,525,162 | −49 | −.5 |
| $75,000, but less than $100,000 | 694,221 | 16,549 | 692,201 | 17,334 | 696,027 | 733 | 4.4 |
| $100,000, but less than $200,000 | 601,179 | 30,652 | 593,129 | 32,105 | 602,234 | 1,341 | 4.4 |
| $200,000 | 153,330 | 111,585 | 152,871 | 131,803 | 153,758 | 19,769 | 17.7 |
| Itemize, total | 35,102,376 | 4,463 | 33,821,197 | 4,683 | 35,730,753 | 49 | 1.1 |
| Less than $10,000 | 18,145,505 | 206 | 11,211,407 | 483 | 20,147,221 | 84 | 40.7 |
| $10,000 but less than $20,000 | 17,120,093 | 1,272 | 15,511,869 | 1,167 | 17,213,091 | −214 | −16.8 |
| $20,000 but less than $30,000 | 7,011,076 | 2,802 | 7,046,050 | 2,172 | 7,056,940 | −616 | −22.0 |
| $30,000 but less than $40,000 | 2,008,097 | 4,855 | 2,032,357 | 3,663 | 2,026,481 | −1,137 | −23.4 |
| $40,000 but less than $50,000 | 500,686 | 7,533 | 502,230 | 6,132 | 502,290 | −1,378 | −18.3 |
| $50,000 but less than $75,000 | 205,251 | 10,772 | 201,538 | 10,781 | 206,853 | −185 | −1.7 |
| $75,000 but less than $100,000 | 39,243 | 17,497 | 33,585 | 19,780 | 39,716 | 2,425 | 13.9 |
| $100,000 but less than $200,000 | 20,885 | 31,490 | 21,125 | 36,285 | 21,125 | 5,152 | 15.4 |
| $200,000 | 3,197 | 152,297 | 3,200 | 154,771 | 3,201 | 2,626 | 1.7 |
| Nonitemize, total | 45,054,432 | 1,392 | 36,569,419 | 1,454 | 47,216,926 | −194 | −13.9 |
| Less than $10,000 | 21,418,088 | 206 | 13,420,833 | 483 | 23,671,682 | 88 | 42.8 |
| $10,000, but less than $20,000 | 24,115,900 | 1,251 | 22,164,931 | 1,220 | 24,411,280 | −129 | −10.3 |
| $20,000, but less than $30,000 | 17,049,120 | 2,622 | 17,151,002 | 2,322 | 17,185,396 | −284 | −10.8 |
| $30,000, but less than $40,000 | 9,246,484 | 4,233 | 9,318,975 | 3,766 | 9,325,146 | −433 | −10.2 |
| $40,000, but less than $50,000 | 4,089,890 | 6,261 | 4,104,863 | 5,788 | 4,106,093 | −450 | −7.2 |
| $50,000, but less than $75,000 | 2,725,274 | 9,715 | 2,721,845 | 9,668 | 2,732,025 | −59 | −.6 |
| $75,000, but less than $100,000 | 733,464 | 16,599 | 731,786 | 17,466 | 735,743 | 824 | 5.0 |
| $100,000, but less than $200,000 | 622,065 | 30,680 | 620,254 | 32,248 | 623,359 | 1,470 | 4.8 |
| $200,000 | 156,527 | 112,417 | 156,071 | 132,274 | 156,959 | 19,419 | 17.3 |
| All returns, total | 80,156,808 | 2,737 | 70,390,616 | 3,011 | 82,947,679 | −89 | −3.3 |

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

As can be seen from the table, taxpayers who do not itemize, on the average, would receive greater benefits from the SELF-tax than those who do itemize. For all taxpayers (itemizers and non-itemizers), those in the less than $10,000 income group (many of whom are now sheltering much income) would have an average tax increase of $88, while the over $200,000 income group would have an average tax increase of $19,419. The middle groups ($10,000-$75,000) would all have tax decreases averaging between $59 and $450 per return.

According to estimates made by the Joint Committee on Taxation, the SELF-Tax Plan, if it were law today, would raise only $7.4 billion less than under current law (see Table 7 above). In effect the SELF-tax Plan is revenue neutral.

With respect to business taxes, I would establish a flat 25 percent rate that would apply to all forms of business, including corporations, partnerships, and farms. Business would be taxed on the base of gross earnings, less the amount paid for goods, services and employee compensation. I would permit a capital recovery allowance to encourage investment in plant and equipment and allow deductions for such normal costs of business as interest and depreciation. Based on calculations made by the Joint Committee on Taxation, a business tax based on these principles can be devised which would raise roughly the same amount of revenues as does the corporate income tax under current law.

As with the individual income tax base, I would repeal the current morass of deductions from the numerous specific business subsidies in the present tax code. Businesses would not be taxed on earnings received from ownership of other businesses, provided the owned business files its own tax return.

Under this general plan, then, all official tax rates would be reduced substantially. The top individual tax rate would drop from 50 to 28 percent. The top business tax rate would be reduced from 46 to 25 percent.

Since the flat rate for corporations (25%) would be very close to the top rate for individuals (28%), there would be very little special inducement for individuals to incorporate, unless they could expect special gains from being taxed under the business tax format.

Overall, the SELF-tax would provide for major improvements in productivity and incentives. Paperwork for business would be cut very radically, as it would for Government. Lower rates would be made possible by the expansion of the tax base. The poorest individuals would pay no tax, and we would retain a slightly progressive individual rate schedule. In addition, business would pay its fair share of the tax burden.

## NECESSITY FOR DEALING WITH THE TAX PROBLEM NOW

The present tax structure, including its numerous preferences and loopholes, is no longer able to raise sufficient revenues for the operation of the Federal Government. If we do nothing to raise revenues we cannot avoid large budget deficits. Such deficits frighten businessmen and investors, causing interest rates to remain very high. This weakens the prospects for a healthy economic recovery. It is clear that Congress must address the issue of long-term revenues if the Federal deficit is to be reduced.

The need to simplify the tax structure is widely recognized. Several bills have already been introduced in the Senate which would order the Treasury Secretary to propose legislation or to draft changes in regulations to provide for massive simplification of the tax code.

If a serious approach to increasing the tax base is not soon adopted, we will face the prospect of either raising rates or adding new taxes. I believe we will all be better off if we took the path of reform. If we do not, we will be perpetuating the present inequities and inefficiencies in the system.

Many advantages would ensue from a program of tax simplification. Americans could once again compute their own taxes. They no longer would have to employ tax preparers to wade through a jungle of incomprehensible regulations. The ease of dealing with the tax system should result in an increase in income reported, and the underground economy would begin to shrink.

The system would be much fairer. People with the same income would pay the same level of tax. There would be no reward to employing high priced tax specialists to gain special benefits by manipulating confusing rules and regulations; there would be relatively few regulations to manipulate. Everyone who pays tax would do so on the same, straightforward basis. This should reduce taxpayer anger and restore basic public respect for the total system.

The system would also be more equitable and more efficient. The poor would not pay anything, the wealthy would pay a higher rate than anyone else, and business would pay its fair share. A substantial burden in paperwork would be lifted from business, government, and individuals alike. Tax considerations would no longer be the driving force behind specific business decisions; the economy would be freer to respond to normal market forces. The result should be higher economic growth and productivity. Overall long-term benefits from such tax reform can be very great and I believe we should begin to consider the issue seriously.

1 See "Productivity and the American Economy: Report and Findings," Subcommittee on Employment and Productivity, Committee on Labor and Human Resources; U.S. Senate September 1982.

2. Eugene Steurle and Michael Hartzmark. "Individual Income Taxation, 1947-1979," National Tax Journal v. 34, June 1981, p. 156.

3 J. Pechman, Federal Tax Policy (Brookings Institution), Table A-2, p. 300.

# STATEMENT OF THE
# AMERICAN PETROLEUM INSTITUTE
# SUBMITTED TO THE
# COMMITTEE ON FINANCE
# UNITED STATES SENATE

Regarding

## HEARINGS ON FEDERAL TAX EXPENDITURES

Washington, D. C.

June 28 and 29, 1983

## SUMMARY

## I. PETROLEUM INDUSTRY PROFITABILITY, CAPITAL EXPENDITURES, AND TAXES

### A. Current Petroleum Situation.

These are troubled times for oil companies. Both demand and prices have dropped substantially from their peak level in 1979, causing a bleak profit outlook for oil companies. This has led to investor concern, and has required many oil companies to reassess and often reduce the scope of their operations, especially when they involve high-cost energy from unconventional sources or frontier regions. But, while oil demand has dropped sharply, the oil crisis is not over, and the industry's success in reversing the decline in U. S. production and diversifying foreign sources of supply would be seriously jeopardized by new or increased taxes.

### B. Oil Industry Profits and Profitability.

Contrary to a widely held misconception that oil industry profits move only up, Chart I demonstrates that profits have sometimes risen and sometimes fallen. Recently, they have dropped precipitously. Furthermore, rate of return on investment is a far more significant indicator of performance than the absolute level of profits. Despite the high risks of petroleum exploration and development, in only seven of the last 15 years has oil company profitability exceeded the average profitability of non-oil manufacturing companies by more than a percentage point. While oil company returns have remained above non-oil company returns from 1979-1982, the difference has narrowed greatly since 1980; and, for 1982, the rate of return on oil company shareholder investment was about 14 percent with no adjustment for inflation -- in line with the industry's historic average.

### C. Capital Expenditures.

Increased profitability provides the incentive for growth in oil industry capital spending and much of the cash and borrowing capacity to finance new investments. Beginning in 1974, petroleum investment more than doubled, reflecting higher profits, and investment continued to climb through 1981. Increased capital expenditures led to more than a tripling of net additions to property, plant and equipment of the leading U. S. oil companies between 1974 and 1981 -- primarily for petroleum activities. The spending especially stimulated new oil production in non-OPEC countries. From 1974 to 1982, oil supply from non-OPEC, Free World countries rose almost 40 percent, and after a decade-long downward trend, U. S. production of crude oil has even been increased somewhat. However, as indicated in Chart III, decreasing profits have led to reductions in 1982 expenditures.

D. Tax Burden.

In the face of receding demand and falling profits, the taxes paid by oil companies have remained high. The petroleum income tax burden alone for 1982 was comparable to that of other companies -- 19 percent. Windfall profit taxes raised that figure to 43 percent, well above the tax burden of other industries -- exclusive of deferred income taxes which are high in industries (such as petroleum) that invest heavily in new plants and equipment, and state severance and property taxes. Federal legislation passed in 1982 placed an even greater tax burden on the oil industry and its customers. The 5 cent per gallon increase in the motor fuels excise tax, effective April, 1983, is expected to raise initially some $4-$5 billion per year. In addition, a Price Waterhouse study prepared for API estimated that six major provisions alone of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") will boost the taxes of 31 large oilcompanies by $11-$15 billion during the 1983-1987 period.

II. TAX EXPENDITURES

A. In General.

1. The Congressional Budget Act treats "tax expenditures" as revenue losses attributable to provisions of the Federal tax laws which deviate from the "normal" tax structure. One of the major problems with the "tax expenditure" concept is the lack of a precise definition of what constitutes this "normal structure." A second problem is that the "tax expenditure" concept suggests the government is spending money to subsidize a special activity or achieve a special purpose, when in many cases the real reason for a "tax expenditure" may be to reduce the effects of disincentives in the existing tax structure.

2. Business "tax expenditures" often help to offset the bias in the existing income tax structure against savings and capital formation. Moreover, in the case of two tax provisions of importance to the oil and gas industry -- the option to deduct intangible drilling and development costs currently and percentage depletion -- "tax expenditures" have the desirable effect of improving the nation's energy security.

B. Intangible Drilling and Development Costs.

1. Intangible drilling and development costs (IDC's) are those costs incurred which, in themselves, have no salvage value and are "incidental to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." The option to deduct currently IDC's is intended to recognize that the search for new oil and gas reserves entails high-risk capital-intensive operations.

2. The following chart summarizes the tax treatment of IDC's:

| Corporations which are integrated oil companies | Corporations which are independent producers | Individuals |
|---|---|---|
| o Currently deduct 85 percent of IDC's<br>o Amortize 15 percent over 36 months | o Currently deduct 100 percent of IDC's | o Currently deduct 100 percent of IDC's<br>o Tax preference item if currently deducted<br>o May elect five-year ACRS with 10 percent ITC if not a limited partnership interest<br>o May elect ten-year amortization |

3. TEFRA reduced the amount of current IDC deductions by 15 percent for all corporations that are integrated oil companies. The 15 percent is allowed as a deduction ratably over a 36-month period beginning with the month in which the costs are paid or incurred. These amounts are not eligible for investment tax credit. During consideration of this change the Senate Finance Committee adopted and the full Senate approved recovery of the 15 percent reduction in IDC's using the five year ACRS schedule with the ITC. This is the same treatment afforded tangible well equipment, and intangible costs such as transportation, labor, etc. involved in the acquisition and installation of other machinery and equipment or in the drilling of water wells for irrigation. Although this rule was not adopted in the final version of TEFRA, its propriety is recognized by the election granted individuals to use five year ACRS with ITC.

4. According to the Congressional Budget Office, measurement of a "tax expenditure" involves a comparison of current tax receipts with what would be collected if the provision had never existed. This task is not easy with current

deductibility of IDC's because there has never been a period in U. S. tax history when taxpayers were completely denied the option to deduct IDC's currently which could serve as the "normal" standard.

5. The current treatment of capitalized IDC's as a depletable investment under Treasury Regulations is not based on sound tax accounting theory but on a questionable IRS interpretation of the discovery value depletion provisions of the Revenue Act of 1918. And with repeal of percentage depletion on most production, there is no basis for continuing to characterize any portion of IDC's as depletable investment.

6. If the IDC and depletion "tax expenditures" had never existed, taxpayers would be recovering IDC's through the same methods of depreciation used for tangible lease and well equipment. For the years 1971 through 1980, this would have been depreciation under 11 year Asset Depreciation Range ("ADR"), with the 7 or 10 percent ITC available. For IDC's occurring in 1981 and later, the standard would be five-year ACRS with ITC. Although this more rapid recovery limits erosion through inflation, even it would not have provided the full protection of expensing or an inflation adjustment during the 1970's.

7. From a practical standpoint, current expensing should be the "normal" recovery method, because it alone avoids the erosion in real value of capital cost recovery through inflation when deductions are spread over a period of years. In effect, the JCT staff recognizes this problem in their Estimates of Federal Tax Expenditures for Fiscal Years 1983-1985, p. 5. Furthermore, since IDC expensing is a "timing tax expenditure", over the life of an oil and gas project, IDC expensing will not reduce the total taxes that will be paid on the income from that project; rather it only defers the payment of those taxes relative to the time of payment under alternative systems of capital recovery such as ADR or ACRS.

8. The right to take a current deduction for IDC's, both because of its positive effect on the present value of the after-tax cost of an investment project and because of its positive contribution to current cash flow, helps to attract investment into oil and gas developments despite the high financial risk and costs. Further limitation of the right would cause withdrawal of significant amounts of capital. As a result, there would be less drilling, less oil produced, and commensurately lower tax receipts because of lower windfall profit and cororate income taxes.

C. Percentage Depletion.

1. Generally, depletion is a method of recovering capital invested in the extraction of oil, gas and certain other minerals with the largest such capital cost being acquistion of the right to extract the commodity. Two types of depletion are available: cost depletion and percentage depletion.

2. Cost depletion is the amortization of all capitalized costs associated with the right to the minerals and their extraction. Typically recovery is on the unit-of-production method -- a type of straight-line recovery which requires that the initial capital is recovered equally by each unit produced. The full capital cost is, however, not recovered until the economic exhaustion of the production. Over the past decade this approach would have failed to keep pace with inflation and provide adequate capital recovery to enable the producer to replace reserves produced.

3. Under percentage depletion, a fixed percentage (currently 16 percent, reduced to 15 percent for 1984 and thereafter) of gross income from producing operations (but limited to 50 percent of net income of the producing property) is available as a deduction for limited volumes for independent producers and royalty owners.

4. Measuring the percentage depletion "tax expenditure" by comparing it to cost depletion as the "norm" is not economically justified. Cost depletion is one of the slowest methods of capital recovery. For a long-lived property, such as an oil or gas project therefore, it substantially decreases the present value of future cost deductions. It also does not account for the enormous amount of inflation experienced during the last decade.

5. Unlike the manufacturing sector where technology developments often make replacement machinery and new investment more efficient at the original or even reduced cost, the petroleum industry faces ever higher costs and higher risks associated with finding new reserves. The only method which even begins to recognize the unique nature of this industry is one based on replacement cost of existing reserves. At the current sales price of developed proven reserves, a rate of percentage depletion equivalent to 25 percent would be required to match the current replacement value of domestic reserves of oil and gas.

Appropriate tax treatment of oil and gas producers depends upon the nation's energy needs and economic priorities. Thus, before turning to a discussion of specific tax expenditures, this statement will review the current petroleum situation, oil industry profitability, the relationship between profits and capital expenditure and, finally, the impact of industry tax burden on the nation's future energy security.

## I. PETROLEUM INDUSTRY PROFITABILITY, CAPITAL EXPENDITURES, AND TAXES

### A. Current Petroleum Situation

These are troubled times for oil companies. Oil consumption in both the U.S. and other industrialized OECD countries has fallen about 17 percent below its 1979 level; and in constant dollars, current Rotterdam spot prices are now about 40 percent below the heights reached during the 1979-80 oil crisis.

With falling oil demand and prices, the profits of U.S. oil companies have suffered. Among 22 major U.S. oil companies, 1982 earnings were almost 30 percent below the level in 1980. In constant dollars (GNP deflator), 1982 profits were down nearly 40 percent.

As a result of these price and profit setbacks, oil companies are reassessing and often reducing the scope of their operations. For the first time since the early 1970's, the total capital expenditures of major U.S. oil companies turned down last year. While costly outlays on oil exploration and development proceeded at record high levels in 1982 -- some five times the 1972 spending level in current dollars -- current and future investment plans are now being reevaluated and sometimes cut back, especially when they involve high-cost energy from unconventional sources or frontier regions. API's latest figures indicate that oil and natural gas well completions during the first quarter of 1983 declined 6.9 percent from the same period in 1982. Total drilling footage declined 15.5 percent, and exploratory well completions declined 11 percent from the year-earlier level. Since the first quarter of 1982, the number of operating drilling rigs has declined by more than 44 percent.

Such cutbacks in oil industry activity are especially unfortunate at a time when the United States needs to continue reducing its dependence on foreign oil. Much progress has been made toward this goal over the past few years. U.S. petroleum imports in 1982 continued their downward trend, averaging 5 million barrels per day -- 0.7 million barrels per day below the 1981 average and 43 percent under the peak level of 8.8 million barrels per day in 1977. Reductions in imports of OPEC petroleum have been particularly pronounced: from 6.2 million barrels per day in 1977 to only 2.1 million barrels per day in 1982. Thus, while the U.S. depended upon OPEC countries for about 70 percent of all petroleum imports as recently as 1977, by 1982, the dependency was down to 42 percent.

A key reason for the reduction in U.S. oil import dependence is the elimination of U.S. oil price controls. Energy users responded to higher prices by buying less oil. And domestic oil producers responded with record levels of investment in oil exploration and production.

The pay-off from such investment has been the stablilization of domestic oil production following a long period of decline. U.S. output of crude oil in 1982 was up an estimated 700,000 barrels a day over what it would have been had oil price decontrol not occurred. And were it not for the so-called "windfall profit" tax that accompanied decontrol, it is estimated that production would have been even higher -- some 1.5 to 2.0 million barrels a day higher by the late 1980's. Presently, 1.5 to 2.0 million barrels a day amounts to more than one third of total U.S. oil imports.

## B. Oil Industry Profits and Profitability

Chart I shows worldwide profits of leading U.S. oil companies for the period 1968-1982 in both current and constant dollars. When the real buying power of a profit dollar is considered, the 1982 profit figure of about $20 billion is equivalent to $8 billion in 1968 dollars. This adjustment for inflation is conservative since it is based on the implicit price deflator for U.S. gross national product, which has risen much less rapidly than the cost of oil exploration and production since the early 1970's. For example, the U.S. producer price index for oil field and gas field machinery rose 1.7 times as much as the U.S. GNP deflator from 1972-1982. Worldwide exploration and production expenditures account for about two thirds of petroleum capital outlays.

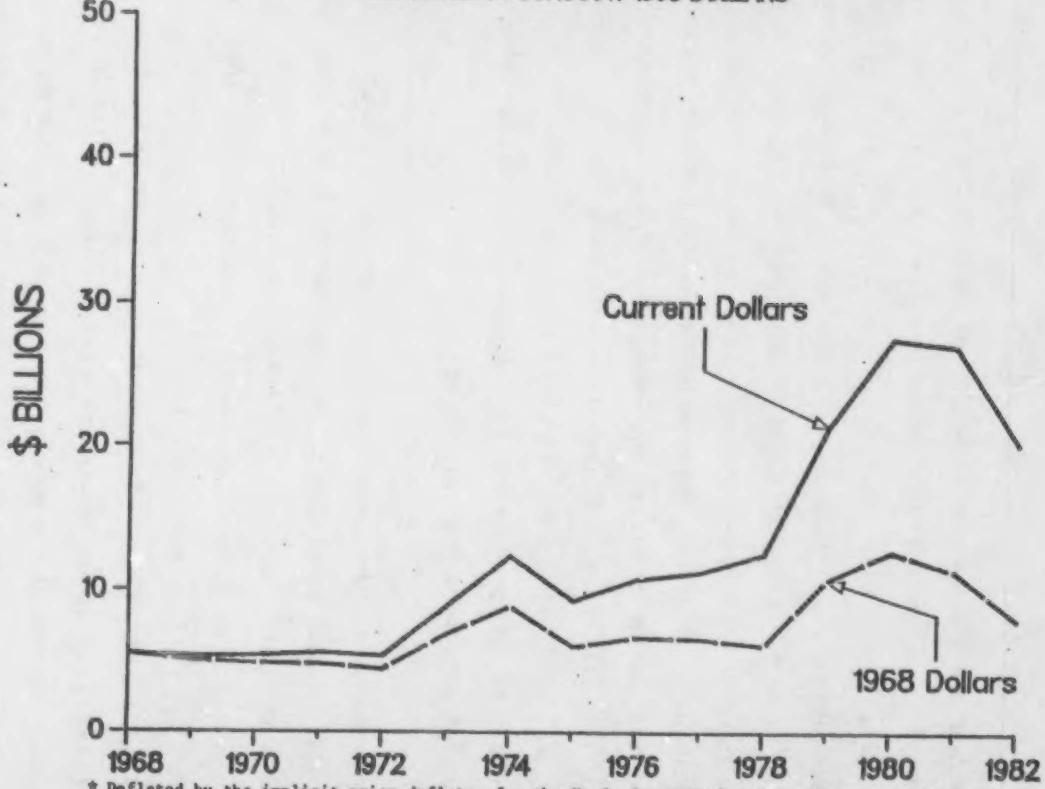
Despite the unusually high financial risks of petroleum exploration and development, in only seven of the last fifteen years has oil company profitability exceeded the average profitability of non-oil manufacturing companies by more than a percentage point. (see Chart II).[1] The oil price increases of 1973-1974 and 1979-1980 only temporarily raised oil industry profitability above other industries. During 1976-1978, oil returns were below non-oil manufacturing returns; and, while oil company returns have remained above non-oil company returns from 1979-1982, the difference has narrowed greatly since 1980. For 1982, the oil rate of return on shareholder investment was about

---

[1] According to Citibank data on worldwide net income as a percent of shareholders' equity.

CHART I

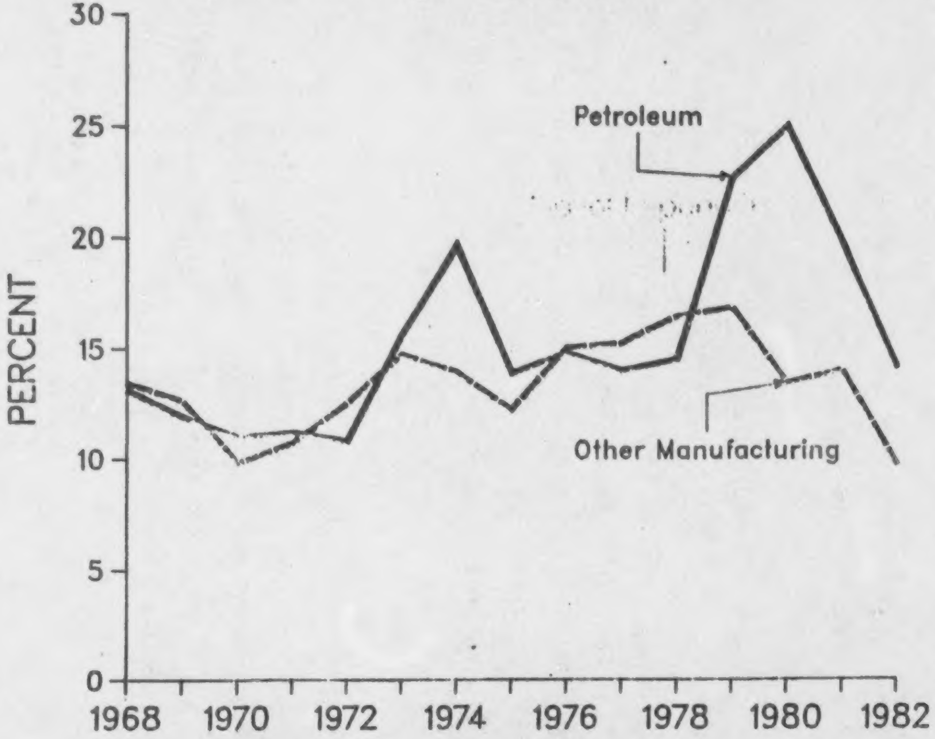
WORLDWIDE PROFITS OF 22 U.S. OIL COMPANIES, 1968–1982
AS REPORTED IN CURRENT DOLLARS VS. BUYING POWER
MEASURED IN CONSTANT 1968 DOLLARS*



* Deflated by the implicit price deflator for the U. S. Gross National Product
Source: American Petroleum Institute, 1981 data are preliminary from Financial Reporting System, based on 1982 EIA Annual Energy Review

CHART II

WORLDWIDE RETURN ON SHAREHOLDER EQUITY, 1968–1982
U.S. OIL COMPANIES VS. OTHER MANUFACTURING
not adjusted for inflation



Source: Citibank *Economic Week*, April issues

14 percent with no adjustment for inflation -- in line with the industry's historic average.

### C. Capital Expenditures

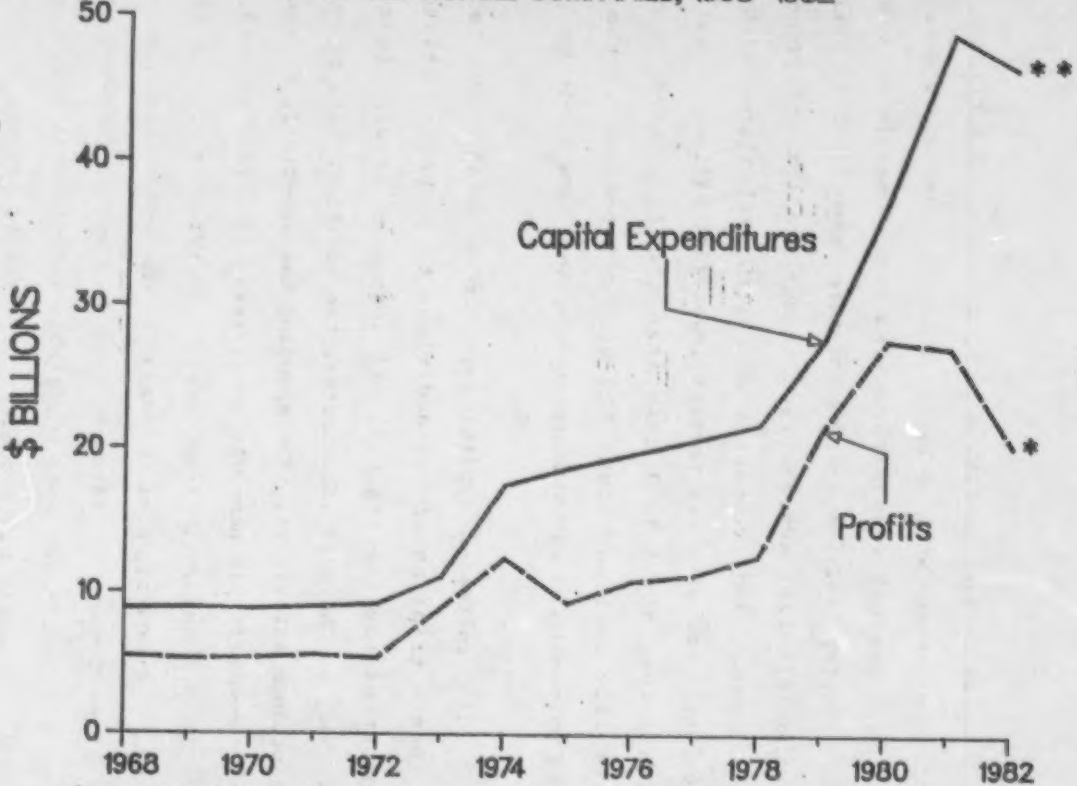
Increased profitability provides the incentive for growth in oil industry capital spending. Profits also provide much of the cash and borrowing capacity required to finance new investments. As Chart III shows, capital expenditures move closely with profits, but there is a lag because of commitments already made on projects having relatively long lead times.

While profits were about constant during 1968-1972, capital expenditures were also constant. Beginning in 1974, petroleum investment more than doubled, reflecting higher profits. The average level of profits during 1974-78 was also about twice the 1968-1972 level.

|  | Profits |  | Capital Expenditures |  |
|---|---|---|---|---|
|  | -------Billion Dollars------- |  |  |  |
| 1968-72 Average | $5 |  | $9 |  |
|  |  | +6 |  | +11 |
| 1974-78 Average | 11 |  | 20 |  |
|  |  | +16 |  | +23 |
| 1980-81 Average | 27 |  | 43 |  |
|  |  | -7 |  | +3 |
| 1982 | 20 |  | 46 |  |

CHART III

WORLDWIDE PROFITS AND CAPITAL EXPENDITURES
OF 22 U.S. OIL COMPANIES, 1968–1982



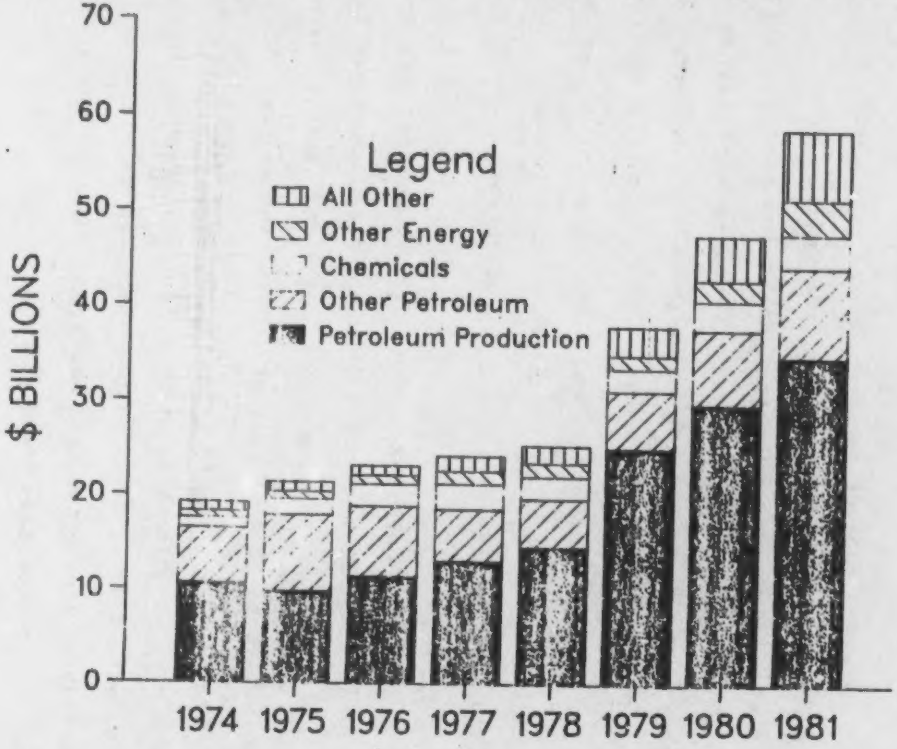
Source: American Petroleum Institute
* 1982 profit figures, preliminary
** 1982 expenditure figures, estimates

By 1980-1981, profits were up by another $16 billion and capital expenditures were up by $23 billion. The larger absolute increase in capital expenditures was made possible by rising profits. During 1982, capital expenditures were still $3 billion above the 1980-1981 average even though profits were some $7 billion lower. And, comparing 1982 with 1981 alone, although 1982 expenditures were six percent lower ($46 billion versus $49 billion), they still fell less than the 25 percent drop in profits ($20 billion versus $27 billion) because of the lag created by committed investments in long lead time projects.

The increased capital expenditure noted above led to more than a tripling of net additions to property, plant and equipment of the leading U.S. oil companies between 1974 and 1981. And, as Chart IV illustrates, the additions were primarily for petroleum activities. The spending has especially stimulated new oil production in non-OPEC countries. From 1974 to 1982, oil supply from non-OPEC, Free World countries rose almost 40 percent. Production of crude oil has even been increased somewhat in the United States after a decade-long downward trend. The welcome result has been a sizeable reduction in OPEC's share of total Free World oil production -- from 64 percent in 1974 to 44 percent in 1982.

CHART IV

WORLDWIDE ADDITIONS TO PROPERTY, PLANT AND EQUIPMENT OF 26 U.S. OIL COMPANIES



Source: Energy Information Administration, U.S. Dept. of Energy

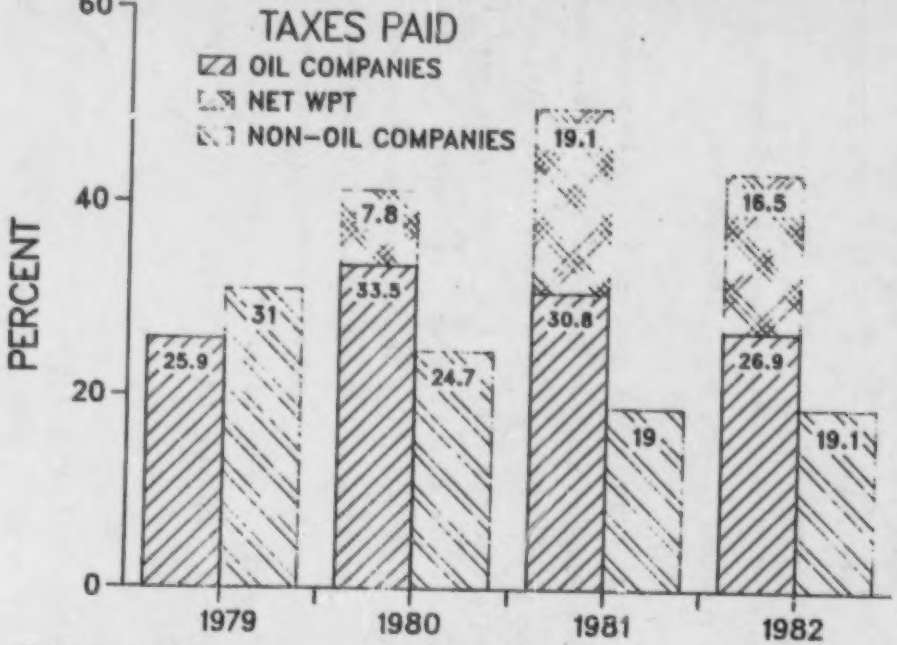
## D. Tax Burden

In the face of receding demand and falling profits, the tax burden of U.S. oil companies has remained high. While the petroleum industry's current federal income tax liability is comparable to the all-industry average, Windfall Profit Tax ("WPT") collections bring it well above the tax burden of other industries. The effect of the WPT in combination with other federal taxes, state taxes, and other payments to governments is to capture about 80 cents of each additional dollar of oil company revenue from U.S. oil price decontrol.

Chart V compares the current federal tax burden of leading U.S. oil and non-oil industrial companies from 1979 through 1982. For oil companies, the total federal tax burden is computed as the sum of current federal income taxes plus the WPT divided by income before such taxes. This burden increased from 26 percent in 1979 to 41 percent in 1980, 50 percent in 1981 and then, with falling crude prices, declined to 43 percent in 1982. The federal income tax rate shown for oil companies in Chart V is what would have been paid without the WPT. Since the WPT is deducted from oil company income, and income tax is levied on the residual, the effective income tax rate of oil companies is higher than the actual ratio of federal income tax payments to income after payment of the WPT. This latter ratio was roughly 31 percent in 1980, 23 percent in 1981 and 19 percent in 1982. Deferred federal income tax liabilities (which arise primarily

CHART V

## COMPARATIVE FEDERAL TAX BURDEN OF LEADING U.S. OIL AND NON-OIL INDUSTRIAL COMPANIES



Source: Corporate
Annual Reports
to Stockholders

1979: 23 Oil Companies and 86 Non-oil Companies
1980–1982: 20 Oil Companies and 75 Non-oil Companies

Note: Oil income taxes shown for 1980–1982 are what would have been paid without the Windfall Profit Tax, which is shown net of the income tax offset. In the WPT computation procedure, the WPT is deducted from income; and income tax is levied on the residual. If there were no WPT, the income tax would be higher —as shown above.

from the difference between accelerated and economic-life cost recovery) are excluded from the calculated tax burdens.

These data also ignore the fact that state and local governments usually tax U.S. oil producers more heavily than other kinds of companies. In particular, these figures exclude the billions of dollars of severance taxes and property taxes on oil and gas reserves paid by U.S. oil producers.

Federal legislation passed in 1982 placed an even greater tax burden on the oil industry and its customers. The five cent per gallon increase in the motor fuels excise tax which went into effect on April 1, 1983 is expected to raise initially some $4-5 billion in federal revenue per year. In addition, the petroleum industry will pay a large share of the taxes collected under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). According to a Price Waterhouse study prepared for the API, six major provisions of TEFRA alone will boost the taxes of 31 large oil companies by an estimated $11-15 billion during the 1983-1987 period.

Even though the oil industry's tax burden is much higher than the average for other industries, some have suggested additional levies on oil producers. New or increased taxes would further reduce returns on investment and sources of funds to an industry already hurt by declining demand and prices. As a result, oil companies would be further constrained in their efforts to find and develop new energy supplies. Such a reduction would jeopardize the progress made in recent years to reduce the world's dependence on OPEC oil.

While oil demand has dropped sharply in recent years and may continue to drop in the years ahead, it is dangerously premature to conclude that U.S. energy problems have ended. Imports still account for about one fourth of U.S. crude oil requirements, and OPEC still controls about 76 percent of Free World oil reserves. A recent General Accounting Office study has noted that the probability of oil supply disruptions remains high and our nation remains vulnerable to periodic shortages.[2] The success that oil companies have had in reversing the decline in U.S. oil production and diversifying oil supplies worldwide ought not to be undone through the imposition of new taxes.

## II. TAX EXPENDITURES

The Congressional Budget Act defines "tax expenditures" as "...those revenue losses attributable to provisions of the

---

[2] "Oil Supply Disruptions: Their Price and Economic Effects." General Accounting Office Report to House Committee on Energy and Commerce, May 20, 1983.

Federal tax laws which allow a special exclusion, exemption or deduction from gross income or which provide a special credit, or preferential rate of tax or a deferral of tax liability." The Administration in its 1984 budget, the Joint Committee on Taxation ("JCT") and the Congressional Budget Office ("CBO") all consider intangible drilling and development costs ("IDC's") and percentage depletion to be tax expenditures because, in the view of each of these entities, the IDC and percentage depletion treatment departs from the "normal structure" for corporate income taxation.

Such classification of these two items ignores one of the major problems with the tax expenditure concept: the lack of a precise definition of what constitutes the "normal structure." In particular, the Administration considers the Accelerated Cost Recovery System ("ACRS") the norm for depreciation while the JCT considers the "guidelines" method of depreciation to be the norm. Many economists would consider current expensing to be the norm. The concept of the "normal structure" being the "basic structural features of the Federal income tax"[3] is thus quite vague and subject to inconsistent interpretation and application.

Another problem with the concept of "tax expenditure" is that it suggests that the government is spending money to subsidize a special activity or achieve a special purpose, even though the real reason for a "tax expenditure" may be to reduce disincentives in the existing tax structure. This is particularly the case with so-called "tax expenditures," such as the dividend exclusion, which actually have the effect of ameliorating the double taxation of corporate income. Moreover, all existing taxes adversely affect economic incentives to some degree. It is therefore sometimes necessary to provide other specialized tax provisions to offset these tax effects if they are particularly strong with respect to some kinds of activities or industries. For example, since the corporate income tax -- a tax on the income from capital -- falls heavily on capital-intensive industries, an investment tax credit is justified to stimulate the modernization necessary for U.S. industry to compete more effectively in markets at home and abroad.

---

[3] The Budget for Fiscal Year of 1984, Special Analysis G at G-1.

Given these considerable difficulties, Congress should be extremely cautious in attempting to cut back on deficits by trimming "tax expenditures." Business "tax expenditures," in particular, often help to offset the bias in the existing income tax structure against savings and capital formation. Moreover, in the case of two tax provisions of importance to the oil and gas industry -- the option to deduct intangible drilling and development costs currently and percentage depletion -- "tax expenditures" have the desirable effect of improving the nation's energy security.

## Intangible Drilling and Development Costs

### A. Background

IDC's are costs incurred for items which, in themselves, have no salvage value and are "incidental to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas." Treas. Reg. § 1.612-4(a). Such costs expressly include wages, fuel, repairs, hauling, supplies, etc., which are incurred in the drilling of wells, in the clearing of ground, and in the construction of derricks, tanks and other physical structures that are necessary for the drilling of wells and the preparation of wells for the production of oil or gas.

For income tax purposes, IDC's are capital in nature and, as such, would ordinarily be taken into account through allowances for depreciation. Under section 263(c) of the Internal Revenue Code and Treasury Regulations promulgated thereunder, taxpayers are permitted to deduct currently IDC's for oil and gas wells and wells drilled for geothermal deposits. Only the holder of a "working" or an "operating" interst (i.e., the interest which is burdened with the risks and costs of developing and operating the property) may currently deduct IDC's. Moreover, the election to deduct IDC's must be made by the taxpayer for the first taxable year in which such costs are incurred and is binding for all subsequent years. At the same time, the costs of all tangible equipment used in drilling and development activities are capitalized and recovered through depreciation.

Section 291(b), which was added to the Internal Revenue Code by the Tax Equity and Fiscal Responsibility Act of 1982, reduces the amount of current IDC deductions by 15 percent for all corporations that are integrated oil companies. The 15 percent is allowed as a deduction ratably over a 36-month period beginning with the month in which the costs are paid or incurred. Sec. 291(b)(2)(A). These amounts are not eligible for investment tax credit and are also subject to recapture on later disposition of the property under Sec. 1254. During consideration of this change the Senate Finance Committee adopted and the full Senate approved recovery of the 15 percent reduction in IDC's using the five year ACRS schedule with the ITC, beginning in the year the property was placed in service. This is the same treatment afforded tangible well equipment, and intangible costs such as transportation, labor, etc. involved in the acquisition and installation of other machinery and equipment or in the drilling of water wells for irrigation, etc. Although this rule was not adopted in the final version of TEFRA, its propriety is recognized by the election granted individuals to use five year ACRS with ITC.

Corporations which are nonintegrated oil companies are allowed to deduct currently 100 percent of their IDC expenditures. Similarly, all individuals are allowed to elect to deduct currently 100 percent of their IDC expenditures. However, if an individual elects to deduct the full amount, he must include the amount of "excess intangible drilling and development cost" in determining tax preferences for purposes of the alternative minimum tax. Treatment as a preference item can be avoided if the individual elects to deduct the costs under a five-year schedule similar to ACRS and claim ITC under Sec. 58(i)(4); or ratably over a ten-year period under Sec. 58(i)(1).

The following chart summarizes the tax treatment of IDC's: .

| Corporations which are integrated oil companies | Corporations which are independent producers | Individuals |
|---|---|---|
| o Currently deduct 85 percent of IDC's | o Currently deduct 100 percent of IDC's | o Currently deduct 100 percent of IDC's |
| O Amortize 15 percent over 36 months--no ITC | | o Tax preference item if currently deducted |
| | | o May elect five-year ACRS with ITC if not a limited partnership interest. |
| | | o May elect ten-year amortization |

## B. Measurement of the IDC "Tax Expenditure"

According to the Congressional Budget Office, computation of a "tax expenditure" involves a comparison of current tax receipts with what would be collected in the absence of a specified provision:

> The revenue loss from each individual tax expenditure is estimated by comparing the revenue raised under current law with the revenue that would be raised if the provision had never existed.[4]

Thus, in order to compute an IDC "tax expenditure," it is necessary to determine what the tax treatment would have been in the absence of the option to deduct IDC's currently.

This task is not easy because there has never been a period in U.S. tax history when taxpayers were completely denied the option to deduct IDC's currently to serve as the standard. Thus, although no specific statutory authority existed for the deduction of IDC's until 1954, the election was first confirmed by administrative ruling in connection with the Revenue Act of 1916. T.D. 2447, issued February 8, 1917, reads as follows:

---

[4] CBO, Tax Expenditures: Budget Control Options and Five-Year Projections for Fiscal Years 1983-1987 (November, 1982), p. 21.

> The incidental expenses of drilling wells, that is, such expenses as are paid for wages, fuel, repairs, etc., which do not necessarily enter into and form a part of the capital invested or property account, may, at the option of the individual or corporation owning and operating the property, be charged to property account subject to depreciation or be deducted from gross income as an operating expense.

The tax treatment of IDC's was an outgrowth of the fact that many taxpayers considered the expensing of such costs to be an acceptable accounting practice. The treatment was also justified as a means of encouraging the exploration and development of our nation's oil and gas resources. Although accounting practices may have changed over the years, the policy to develop domestic oil and gas resources still supports the need for rapid recovery of IDC's for tax purposes. Indeed, financial risks have escalated as industry must more frequently drill in high-cost, hostile offshore and frontier environments.

If current expensing of IDC's had never been permitted, the conceptually proper method for recovering these costs over time would have been to have treated them as part of the depreciable investment in lease and well facilities like the items of tangible well investment are treated today. The current treatment of capitalized IDC's as a depletable investment under Treasury Regulations § 1.612-4(b) is not based on sound tax accounting theory but on a questionable IRS interpretation of the discovery value depletion provisions of the Revenue Act of 1918.

With the advent of discovery value depletion in 1918, the IRS changed its position announced in T.D. 2447 and contended that the depletable value of the well included capitalized IDC's except to the extent they were represented by physical property which was still considered depreciable. (Regulations 45, Art. 223.) The IRS continued to take the same position after percentage depletion was substituted for discovery value depletion in 1926. (Treas. Reg. § 1.612-4(b) -- current regulations.)

With repeal of percentage depletion on most production, there clearly is no basis for continuing to characterize any portion of IDC's as depletable investment. In any event, if the IDC and depletion "tax expenditures" had never existed, taxpayers would be recovering IDC's through the same methods of depreciation used for lease and well equipment, just as such costs are recovered under generally accepted accounting principles for financial statement purposes. (See Financial Accounting Standards Board Statement No. 19, paragraph 35.)

For the years 1971 through 1980, the proper treatment for tax purposes in the absence of expensing would have been to recover IDC's through depreciation under 11 year Asset Depreciation Range ("ADR"), with the seven or ten percent ITC available. Exhibit A illustrates the amount of IDC expenditures in current dollars and as adjusted for inflation and "tax expenditures" under various criteria for each year from 1971 through 1980, the years ADR was in effect, for the API-Price Waterhouse survey group of companies. Exhibit A assumes that ADR plus investment tax credit was in effect for years prior to 1971 for purposes of illustration.

Exhibit A illustrates several points:

(1) assuming a consistent methodology of recovery, a constant level of investment expenditures for the preceding investment cycle and no pre-1971 inflation, as is the case in the computation for 1971, there is no tax expenditure that year because the amount deducted using ADR is the same as that deducted using current expensing. Additionally, had IDC's been capitalized as depreciable, producers would have enjoyed the full benefit intended under the investment tax credit provisions for the 1971 expenditures;

(2) excluding ITC, more than 85 percent of the apparent "tax expenditures"indicated in Exhibit A for years after 1971 is attributable to inflation. For years 1972 through 1980, there are apparent "tax expenditures" of $5,448 million compared to "tax expenditures" of $758 million if IDC's are adjusted for inflation;

(3) since the investment tax credit during these years by no means fully compensated for the erosion of inflation, it could not serve as the investment stimulus it was intended to be;

(4) when the investment tax credit is considered and the effects of inflation are eliminated, the IDC deduction results in greater real revenue to the government today than would have been the case with "normal" depreciable treatment -- a "negative tax expenditure" of $143 million for 1972-80.

For IDC'S occurring in 1981 and later, the appropriate depreciation standard is the same as that for tangible investment, five-year ACRS with ITC. This method comports with the Administration's 1984 budget which states that the norm for determining tax expenditures is the Accelerated Cost Recovery System. Although the more rapid recovery limits erosion through inflation, even the combination of ACRS and ITC would not have provided the full protection of current expensing or an inflation adjustment during the 1970's. From a practical standpoint, there is no perfect substitute for current expensing, but in its absence, use of five-year ACRS with ITC as the standard avoids the complexity of an inflation adjustment and the controversy as to the proper index to be employed.

The staff of the JCT has focused attention on the inflation problem in its explanation of the tax expenditure concept in Estimates of Federal Tax Expenditures for Fiscal Years 1983-1988, March 7, 1983 at p. 5:

> One of the problems with the staff's definition of the depreciation tax expenditure is that it neglects the effect of the inflation in eroding the real value of depreciation deductions. Even with accelerated depreciation, taxpayers will not always receive deductions whose real value corresponds to the amount they originally paid for the asset. A similar problem arises in the definition of the tax expenditure for capital gains. The staff is studying whether to alter the definitions of these and other tax expenditures to take account of the distortions caused by inflation.

In effect, the JCT staff acknowledges that any period of capital recovery longer than immediate expensing will result in deductions worth less than the original cost of the investment during a period of rising prices. Indeed, even in a period of stable prices, the present value of deferred capital recovery must be less than original value as long as money has a time value (i.e., there is a positive discount rate).

Aside from inflation and the question of which norm to use, the JCT staff's method endeavors to measure the expenditure "as if the provision had never existed" by using as the norm a ten-year recovery period (double declining balance, switch to straight line in year seven). Although not characterized as "depreciation," this method yields results quite similar to eleven year double declining balance with a switch to sum-of-the-years-digits as used under ADR for tangible well investment (without ITC) and in the calculation in Exhibit A. Thus, a large portion of the JCT's estimate for the IDC's tax expenditure is attributable to inflation.

There will be no "tax expenditure" as defined by the JCT, even with IDC expensing, as long as there is no growth in IDC's either from inflation or real growth (i.e., a steady state system). For example, if IDC's or any other timing difference item were $100 every year, and ten-year straight-line amortization were the standard of "tax expenditure" calculation, after one ten-year cycle had been completed, the cost recovery deduction would be $100 per year -- equal both to IDC expensing and to the sum of the $10-per year straight-line depreciation increments for each of the ten recovery years. If, however, there is growth in IDC's, adjusting for inflation leaves only increases attributable to real increases in IDC's which are desirable to secure a reasonably priced, secure source of petroleum for the future.

In contrast to this method is the CBO approach, for example, which appears to measure only the initial revenue effects of changing recovery methods, not the "expenditure" as if current expensing had never existed. This defect in methodology accounts for tax expenditure estimates which are unrealistically high by a factor of as much as three, as compared to the JCT method.

Viewed from a different perspective, the flaw in the measurement of any depreciation "tax expenditure" is that the very concept fails to acknowledge that over the life of a project, accelerated depreciation defers but does not reduce the total amount of taxes paid to the government. Hence, there is a zero tax expenditure for any given investment in its entirety. That is, IDC expensing does not reduce the total taxes that will be paid to the government on the income from an oil and gas project; rather it only defers the payment of these taxes relative to the time of payment under alternative systems of capital recovery such as ADR or ACRS.

Even though IDC "tax expenditures" must be small or nonexistent if properly measured, the election to expense IDC's is vital to oil and gas investors both because of its positive effect on the present value of the after-tax cost of an investment project and because of its positive contribution to current cash flow.

Exhibit B presents the present value of recovery allowances and the ITC for a dollar of IDC's under various recovery methods. Current expensing, of course, provides full recovery of capital values regardless of the discount rates used or the amount of inflation assumed. The present five-year ACRS with ITC under either the ten percent with basis adjustment approach or eight percent without basis adjustment yields comparable present value recovery at a ten percent discount rate, but falls short at the higher rates required in petroleum exploration and production. Other methods miss the mark by even wider margins. For example, if the TEFRA 36-month amortization treatment were extended to 100 percent of IDC investment, the present value gap would be considerably more than even that for the pre-1981 eleven-year ADR with ITC. The JCT method, which excludes ITC, would result in present value recovery of less than three-fourths of the IDC's incurred.

Thus, the right to take a current deduction for IDC's substantially improves the financial attractiveness of oil and gas exploration and production relative to recovery over time. Costs recovered in the present are less burdensome than costs recovered in the future, especially in a period of high inflation and interest rates. Moreover, many members of the industry, both large and small, do not readily have the cash resources or borrowing ability to absorb the additional costs which would be caused by deferring deduction of drilling expenditures. For many taxpayers, the immediate cash flow generated by the IDC deduction can be an absolute prerequisite to participation in the industry.

The right to deduct the IDC expenditures has been a part of oil and gas tax law since the inception of the income tax. It is an important right since it helps to attract investment into oil and gas development despite the high financial risks and costs. Oil and gas wells are expensive and have rapidly become more so as the search for new supplies has extended into harsher environments and farther offshore in greater water depths. Only about one in five wildcat wells find oil in commercial quantities and many of those fail to cover their total costs. Numerous dry holes are encountered even in drilling operations in areas where oil and gas reserves are known to exist.

Further limitation of the right to deduct IDC expenditures currently would cause the withdrawal of significant amounts of capital from oil and gas exploration and development. As a result, there would be less drilling and less oil produced with the attendant loss of tax receipts because of lower windfall profit and corporate income taxes. See, The Economic Impact of the Intangible Drilling and Development Costs ("IDC") Tax Provision on the Petroleum Industry, April 1983. Prepared for the American Petroleum Institute by Price Waterhouse.

## Percentage Depletion

### A. Background

Generally, depletion is a method of recovering capital invested in the extraction of oil, gas and certain other minerals. As in other businesses, certain costs are considered capital investments and not eligible to be currently expensed.

Typically the largest such capital cost is the cost of acquisition of the right to extract oil, gas, or other minerals. This is treated as a capital cost for both financial and tax accounting. A significant portion of capitalized costs of an oil or gas property (for tax purposes) consists of geological and geophysical costs associated with surveying and evaluating a potential oil and gas property. Although these costs may be expensed for financial purposes, they must be capitalized for tax purposes. In this sense if the "tax expenditure" concept is valid, this treatment is a "reverse expenditure" or the denial of normal recovery methods to the taxpayer. Moreover, it diverts the attention of exploration personnel from their primary function of searching for oil and gas by requiring them to ascertain which expenditures lead to the acquisition or retention of a particular property.

For tax purposes depletion is the prescribed method for recovery of capital for this investment. Two types of depletion are available under the Internal Revenue Code.

The first type of depletion is cost depletion. Cost depletion is the amortization of all capitalized costs associated with the right to the minerals and their extraction. Typically recovery is on the unit-of-production method. This is a type of straight-line recovery which requires that the initial capital is roughly recovered equally by each unit produced. The full capital cost is, however, not recovered until the economic exhaustion of the production. Over the past decade this approach would have failed to keep pace with inflation and provide adequate capital recovery to enable the producer to replace reserves produced.

The second type of depletion is percentage. Under that method a fixed percentage (currently 16 percent, reduced to 15 percent for 1984 and thereafter) of gross income from producing operations (but limited to 50 percent of net income of the producing property) is available to a taxpayer as a deduction. As in the cost depletion calculation, the deduction will reduce the remaining basis or unrecovered investment in the property (but not below zero).

Since the Tax Reduction Act of 1975, percentage depletion has been available only with respect to certain oil or gas up to 1,000 barrels per day of oil (or equivalent) if produced by, or on behalf of, an "independent producer or royalty owner," i.e., not an integrated oil company. Percentage depletion has been repealed for the major integrated company except for a small portion attributable to gas, the price of which has been fixed at very low rates by contract and by regulation.

### B. Percentage Depletion as a "Tax Expenditure"

Comparing tax receipts under current law against those that would have been collected had there never been percentage depletion initially appears to be a simple task, if one assumes that the "normal structure" is cost depletion. However, a cost depletion norm is not economically justified.

Unlike the situation in the manufacturing sector of our economy where technological developments have often made replacement machinery and new investment more efficient at the original or even reduced cost, the situation in the petroleum industry is one of higher costs and higher risks associated with finding new reserves. Reserve additions have increasingly been located in deeper zones or in otherwise more operationally difficult, and hence expensive, areas like deep offshore waters, the Alaskan Arctic, etc. Drilling costs have escalated as many wells have been drilled deeper and reserves discovered per well drilled have become smaller.[5] Yet for a long-lived property, cost depletion, one of the slowest methods of capital recovery in the Code, substantially decreases the present value of future cost deductions. By contrast, ACRS investors in manufacturing equipment enjoy present value recovery more nearly equivalent to current expensing since they are able to deduct their investment within a minimum of five years after operation begins, even if the expected productive life of the investment is longer.

Not only does cost depletion fail to recognize the higher real replacement costs in the oil and gas industry, it also does not account for the enormous amount of inflation experienced during the last decade, as noted earlier in relation to IDC's. The industry's real cost of capital invested in the acquisition of oil and gas properties in recent years has been substantially "underrecovered" due in large part to inflation. Only current expensing completely mitigates the effects of inflation, while ACRS with the ITC does much to neutralize it. But neither of these methods is available for "depletable costs." The oil and gas industry is thus penalized both by its high risk, high cost nature and by inflation while other much less risky industries have been allowed more generous capital recovery mechanisms and investment stimuli (i.e., the ITC).

---

[5] (See statistics contained in the Annual Survey of Oil and Gas, published by the Bureau of the Census, and the Joint Association Survey.)

The only method which even begins to recognize the unique nature of this industry is one based on the cost of replacing existing reserves. The income generated by the sale of production from these reserves represents the consumption of a nonrenewable capital asset. As such, it is reasonable to consider the cost of replacing the reserves as the base on which capital recovery allowances should be computed, rather than historical cost. Indeed, Congress first adopted percentage depletion in 1926 as a substitute for depletion based on value of reserves in the ground, and for nearly 50 years it served as an effective yet simple measure of replacment cost recovery. The current rate for percentage depletion (16 percent) falls substantially below the current value of reserves in the ground as a percentage of wellhead price.

The current sales price of developed proven reserves of oil are reported in the press to average about $7-8 per barrel in the ground depending on a number of variables including individual well and reservoir characteristics and differing investment objectives. This cost is equivalent to roughly 1/4 of the average current wellhead price of oil. Thus a rate of percentage depletion equivalent to 25 percent would be required to allow sufficient capital recovery to match the current replacement value of domestic reserves of oil and gas. In contrast to other methods of adjusting for inflation (such as indexing costs) this method is simple to administer and reaches the desired objective.

EXHIBIT A

## IDC Tax Expenditure Analysis*

| Year | IDC's | | ITC(3) Amount | | "TAX EXPENDITURE" USING CRITERIA INDICATED ($ Million) | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | ADR-Unadjusted | | ADR-Adjusted for Inflation(1) | |
| | Unadj. | Adj.(1) | Unadj. | Adj.(1) | W/O ITC(2) | With ITC | W/O ITC | With ITC |
| 1971 | 813 | 813 | 57 | 57 | -0- | (57) | -0- | (57) |
| 1972 | 874 | 801 | 61 | 56 | 26 | (35) | (5) | (61) |
| 1973 | 912 | 772 | 64 | 54 | 30 | (25) | (17) | (71) |
| 1974 | 1,271 | 836 | 89 | 59 | 188 | 99 | 14 | (45) |
| 1975 | 1,951 | 1,004 | 195 | 100 | 449 | 254 | 85 | (15) |
| 1976 | 2,354 | 1,107 | 235 | 111 | 542 | 307 | 114 | 3 |
| 1977 | 2,945 | 1,197 | 295 | 120 | 696 | 401 | 132 | 12 |
| 1978 | 3,335 | 1,121 | 334 | 112 | 727 | 394 | 73 | (39) |
| 1979 | 4,079 | 1,146 | 408 | 115 | 862 | 454 | 65 | (50) |
| 1980 | 7,047 | 1,741 | 705 | 174 | 1,920 | 1,215 | 297 | 123 |
| 1972-80 | 24,768 | 9,725 | 2,386 | 901 | 5,448 | 3,064 | 758 | (143) |

(1) Inflation adjustment is based on footage rate data in the "Joint Association Survey of the U.S. Oil and Gas Producing Industry", API.

(2) Yields essentially same result as JCT "tax expenditure" methodology.

(3) 7% 1971-74, 10% 1975-80

* Source: Data from "The Economic Impacts of the Intangible Drilling and Development Costs (IDC) Tax Provision on the Petroleum Industry" prepared by Price Waterhouse & Co.

EXHIBIT B

## COMPARISON OF THE PRESENT VALUE OF VARIOUS COST RECOVERY ALLOWANCES AND THE INVESTMENT TAX CREDIT (ITC)

| | $ | | | | | |
|---|---|---|---|---|---|---|
| | Present Value for $1.00 investment | | | | | |
| | @15% | | | @10% | | |
| | Cost Recovery | ITC | Total | Cost Recovery | ITC | Total |
| **Equipment** | | | | | | |
| 5-year ACRS (Production & Refining) | | | | | | |
| - with 10% ITC, basis adjustment for 1/2 of ITC | .72 | .22 | .94 | .78 | .22 | 1.00 |
| - with 8% ITC, no basis adjustment | .76 | .17 | .93 | .83 | .17 | 1.00 |
| 11-Year ADR with 10% ITC under prior law (Production) | .63 | .22 | .85 | .72 | .22 | .94 |
| 13-Year ADR with 10% ITC under prior law (Refining) | .59 | .22 | .81 | .68 | .22 | .90 |
| **Intangible Drilling and Development Costs (IDC)** | | | | | | |
| Current expensing -- full investment is deducted in the year cost is incurred, no investment tax credit (ITC) | 1.00 | -0- | 1.00 | 1.00 | -0- | 1.00 |
| TEFRA, H.R. 4961 treatment of IDC 85% current expensing, 15% recovered through 36 month straight-line amortization with no ITC or basis adjustment(1) | | | | | | |
| - 15% capitalized | .97 | -0- | .97 | .98 | -0- | .98 |
| - If 100% were capitalized | .82 | -0- | .82 | .87 | -0- | .87 |
| H.R. 4961 (Senate 1982) treatment of intangible development costs (IDC) 85% current expensing, 15% recovered under 5-year ACRS with 10% ITC and basis adjustment for 1/2 of ITC | | | | | | |
| - 15% capitalized | .96 | .03 | .99 | .97 | .03 | 1.00 |
| - If 100% were capitalized | .72 | .22 | .94 | .78 | .22 | 1.00 |
| JCT Staff "Tax expenditure" methodology | .63 | -0- | .63 | .72 | -0- | .72 |

Note: (1) Assumes half-year averaging convention.

6/30/83

# API STATEMENT ON FEDERAL BUDGET AND TAX POLICY

The U.S. economy has experienced three years of stagnation during which unemployment of labor and capital resources has risen to unacceptable levels. At the same time, the federal budget deficit has increased dramatically, and large deficits loom in the years ahead. Some have suggested that substantial new taxes should be imposed at this time in order to reduce prospective near-term deficits. Others have proposed enactment of contingent taxes in order to guard against excessive deficits over the longer term. This statement first discusses the American Petroleum Institute's position on budget and tax policy. It then discusses energy taxation proposals.

## General Tax Policy Over the Near-Term

In recent weeks and months, there have been some signs -- for example, in housing starts, auto sales, and employment -- that the economy is picking up. Most economists agree that an economic recovery is under way or is about to begin. But the signs are tentative. It is quite important, therefore, that federal fiscal policy at this time not take a restrictive turn which could delay or abort economic recovery.

Tax increases of any sort are by their nature contractionary. Tax increases on business weaken incentives to hire people and to make new capital investments. Taxes that reduce consumer spending shrink markets, and hence they also adversely affect demand for labor and new capital. The economic impact of any new tax, of course, depends upon the magnitude and type of tax imposed. However, in general tax increases constrain economic activity.

Those who support additional taxes to reduce near-term federal deficits argue that deficits of the magnitude currently anticipated will result in higher interest rates and, therefore, economic stagnation and continued high unemployment. The underlying reasoning is that large-scale federal borrowing forces interest rates upward. The higher rates in turn discourage business investment, housing demand, and consumer demand for durables, keeping the economy in recession or at least preventing substantial real growth.

However, both economic theory and historical experience indicate that in the short-term there is no consistent relationship between federal deficits and interest rates. Federal borrowing is just one factor affecting interest rates. Private investment demand as well as the supply of private saving -- which finances both federal borrowing and private investment -- are other key determinants. Examples of earlier years when federal deficits have risen while interest rates have fallen or been stable are 1958, 1971 and 1975. Generally, this inverse relationship has occurred during periods, like the current one, when private investment demand has been relatively weak. Indeed, experience during the past year, when interest rates fell substantially despite a large increase in federal borrowing and even larger projected deficits, confirms the fact that growing deficits do not necessarily mean higher interest rates.

Economic considerations, therefore, do not support the view that it is necessary to reduce the present federal budget deficit in order to stimulate the economy. Economic analysis and experience, however, do suggest that during periods of substantial unemployment like the present it would be counterproductive to raise taxes.

## Longer-Term Considerations

Although we believe that new taxes of any type would be harmful at this time, we realize that structural deficits of the size projected for the longer-term are cause for concern. As recovery proceeds, substantial federal borrowing could displace private investment that would otherwise occur. Moreover, pressure would mount on the Federal Reserve System to monetize the federal debt in order to keep interest rates from rising. This would have inflationary consequences.

Thus, economic considerations suggest that it would be beneficial to take actions which would reduce projected future federal deficits. An immediate benefit would be improved investor confidence about the nation's ability to deal with fiscal problems. In the longer term, benefits would accrue from the reduced federal borrowing implied by the lower deficits.

We believe that an all-out effort should be made to effect a deficit reduction through new initiatives to reduce the rate of federal spending growth. A significant decrease in the growth of federal spending would signal that the federal government can control its budget and is serious about doing so. Business and consumer confidence would improve. Less federal spending would mean that more private saving will be available for private investment, which will boost long-run economic growth. Moreover, by reducing pressure on interest rates, a reduction in federal spending growth would alleviate the danger that the Federal Reserve will fuel inflation by monetizing too much federal debt.

New taxation is the other alternative. But experience indicates that rising tax revenues do not necessarily lead to smaller deficits. There is a danger, then, that new taxes will result primarily in increased federal spending, with little or no improvement in the deficit situation.

New taxes to reduce projected budget deficits pose other problems as well. First, such taxes can reduce private savings necessary to finance private investments as well as public spending. If this happens, financial markets will not be much helped by the assumed deficit reduction. And second, taxes generally would reduce incentives to work and/or invest, thereby reducing real income and savings. Thus, tax increases could be self-defeating for this reason as well.

Recent history suggests that the process for projecting future budget deficits is, at best, inexact. Because estimates of federal revenues and expenditures on which deficits are based are sensitive to the level of economic activity, and because predictions of that activity are imprecise, the margin of error is great. For example, even the month-to-month changes in economic statistics over the past several months have caused continuing fluctuation in the deficit projections for fiscal year 1984. If in fact deficits do develop, they should be dealt with when the facts of their magnitudes are closer at hand.

Even with these problems, it may be that new taxes for the longer term will be considered. Tax policy, however, should be made with up-to-date information on relevant factors. Levels and trends in unemployment, capital utilization, private borrowing, interest rates, government spending, federal deficits, etc., are important factors to be considered in deciding upon appropriate tax policy.

## Energy Taxes

We realize that some consider the petroleum industry a particularly desirable target for new taxes. The popularity of oil industry taxation proposals appears to rest on two common but erroneous beliefs; first that the oil industry is more profitable than other industries generally, and second that the petroleum industry is presently under-taxed compared with other industries. The record should be set straight on these matters.

Over the longer term petroleum industry rates of return are comparable to average returns in U.S. industry. For example, according to data compiled by Citibank, during the 1968-1981 period the median return on stockholders' equity for petroleum companies was 14 percent -- about the same as the median return for non-oil manufacturing firms.

Although Citibank figures are not yet available for 1982, the American Petroleum Institute (API) has collected profit data for 23 leading petroleum companies. The API data indicate that during the first three quarters of 1982 the average rate of return for these oil companies was 13.5 percent.

Another misconception which often influences thinking about taxation is that the oil companies do not pay their "fair share" of taxes. On the contrary the petroleum industry is more heavily taxed than other industries. Recent studies have confirmed the fact that the petroleum industry's current federal income tax burden is above the average for non-oil industrials. These results are included in two studies for 1981. One was prepared by the staff of the Joint Committee on Taxation and the other by the publication Tax Notes. However, neither of these studies takes into account the impact of the "Crude Oil Windfall Profit Tax" (WPT), the large excise tax on domestic crude oil production. For 1981 these studies indicate a level of current federal income tax for leading U.S. oil companies ranging from 18% to 22% of pre-tax net income, slightly above that for the leading non-oil industrials. When the windfall profit tax is included, the petroleum industry's current federal tax burden increases to almost half of pre-tax net income. If the windfall profit tax had not been enacted, the current federal income tax burden for the petroleum industry would be about 30% of pre-tax net income, almost 1 1/2 times that of the leading non-oil companies.

Moreover, these measures of oil industry tax payments do not reflect deferred taxes, taxes on oil products such as the motor fuel excise taxes, state and local income taxes, or the many special taxes that state and local governments impose on oil companies. For example, some states have gross receipts taxes directed exclusively at petroleum companies. State and local governments also collect billions of dollars annually from oil companies in severance taxes and in property taxes on oil and natural gas reserves. And, in 1982 thirty-three states introduced tax legislation that applied only to the oil industry.

Federal legislation passed in 1982 -- the five cents per gallon increase in the motor fuels excise tax which will go into effect on April 1, 1983, and the Tax Equity and Fiscal Responsibility Act (TEFRA) -- placed an even greater tax burden on the oil industry.

As with other commodities, consumers cut their purchases of motor fuels when prices rise. Hence, the increase in the motor fuels tax is likely to affect adversely oil firm sales and profitability. This will come at a time when the refining industry already has much excess capacity and the number of marketers has decreased considerably.

In addition, a Price Waterhouse study prepared for the API indicates that the petroleum industry will pay a large share of the taxes collected under TEFRA. According to this study, six provisions of TEFRA will raise between $11.5 billion and $22.7 billion from 31 large oil companies during the 1983-1987 period, the exact amount depending on petroleum industry growth. A medium scenario in which the oil industry is projected to grow at about the same rate as the overall economy would result in increased taxes on these oil companies of about $15 billion, or about 15 percent of all revenues expected to be raised under TEFRA's business tax provisions during this period.

Despite falling petroleum industry profits and rising petroleum taxes, there are suggestions for additional petroleum taxes. Some suggestions -- such as the proposal for a national crude oil severance tax which was put forward during the last session of Congress -- are aimed directly at domestic oil producers. By reducing incentives to find and produce domestic oil, such taxes would reduce future domestic production, increase reliance on imported oil, and play into the hands of OPEC. For this reason, these taxes would harm this country's energy well-being.

Much progress has been made over the past few years in reducing U.S. dependence on oil imports. U.S. oil imports averaged 4.8 million barrels per day in 1982, down about 45 percent from the peak level of 8.8 million barrels per day in 1977.

The reduction in U.S. oil imports largely stems from the return to a free market in oil as a result of the elimination of price controls. Consumption declined as oil users responded to higher prices by increasing the efficiency of their oil use. Also, production of oil in the U.S. stabilized after a long period of decline. The decontrol of oil markets resulted in record levels of exploration and production investment in the U.S. which, in turn, brought about reversal of the trends in finding and producing oil.

The U.S. produced about 3.2 billion barrels of oil in 1982. This represented about 11 percent of the estimated proved reserves of the U.S. at the start of the year. Obviously, if the U.S. is to continue to produce domestic oil at such a rate (which if no new reserves were found would exhaust our known and proven reserves in about nine years), there must be substantial, regular new additions to the reserve inventory. If the U.S. is to maintain a significant production level into the 1990s, then the reserve base for such production must be found and developed. Much will necessarily have to come from as yet undiscovered domestic sources.

The use of market forces in the U.S. is a proven means to enhance production from domestic resources. For example, domestic production of crude oil is up an estimated 900,000 barrels a day over what it would have been had oil price decontrol not been initiated by President Carter and completed by President Reagan. And were it not for the so-called "windfall profit tax" that accompanied decontrol, domestic production would be even higher -- some 1.5 to 2.0 million barrels a day higher by the late 1980's, according to estimates. Additional taxes on oil production will make it even less attractive and will push future production further below what could be achieved.

In addition to tax proposals aimed at the domestic oil production sector, proposals also have been made to tax all oil use or to tax oil imports.

The Proposed Contingent Oil Tax

President Reagan has proposed a $5 per barrel oil excise tax which would take effect in fiscal 1986 only if three conditions are met in mid-1985: (1) the economy is expanding; (2) the fiscal 1986 deficit is projected to exceed 2.5 percent of the gross national product; and (3) the Congress has previously agreed to the Administration's proposed spending constraints.

Assuming that annual domestic oil consumption in 1986 and beyond will be 5-6 billion barrels, the proposed $5 per barrel tax would gross $25-30 billion per year. However, the tax would raise net federal revenues by substantially less than this amount. Because of the diversion of funds to pay the tax, aggregate business receipts net of the tax would fall by about $25-30 billion per year. Hence, the federal government's base for personal and business taxes would fall commensurately. Federal tax collections other than the oil tax would fall, and this reduction would partially offset the revenues raised by the oil tax.

The proposed contingent oil tax is not in the national interest. There are fundamental disadvantages of an oil tax, and the contingency feature adds to the problems as outlined in the points below:

- A new oil tax would weaken the ability of much of U.S. industry to compete with foreign counterparts. Higher oil product prices would result in increased demand for substitute energy sources such as natural gas and coal, and thus would raise energy costs generally. Energy is a key input to a great many U.S. industries. If U.S. industries are burdened by higher production costs related to a new oil tax while foreign counterparts are not, the inevitable result will be a loss of competitiveness for U.S. firms, both in overseas markets and in competition with foreign firms at home. Thus, energy dependent industries such as agriculture, petrochemicals, steel, aluminum and others would have lower capital utilization and more unemployment.
- Although an oil tax would reduce energy use, it would tend to reduce overall economic efficiency. Energy-using industries would tend to substitute other resources for higher cost energy, but this would result in a less productive mix of inputs and lower national output. In addition, while an oil tax may stimulate production of

substitute domestic energy sources, some non-oil domestic energy would be produced at costs greater than the resource costs (the non-tax costs) of an energy-equivalent amount of oil.

- An oil tax would tend to shrink the market for petroleum products, causing further losses of facilities and jobs in refining and marketing. The refining segment is operating at about two-thirds of capacity even after closing many facilities. And the number of gasoline service stations, most of which are owned and operated by small businessmen, already has declined by about 80,000 during the past 10 years. The newly enacted 5 cents per gallon motor fuels tax will depress petroleum refining and marketing further. An oil tax would add to these problems.
- A contingent oil tax would increase investor uncertainty in the next few years and thus reduce investment. Energy users would face new uncertainty about what investments to make in equipment because of the added uncertainty about energy costs. At the same time, energy suppliers would face increased uncertainty about the future size of the markets they supply, and therefore would hesitate in making capital commitments. The result would tend to be less total investment and reduced economic growth.
- Consumers would have to pay significantly higher prices for oil products. A $5 per barrel oil tax would result in about a 12 cents per gallon increase in product

prices, on average, if the tax were completely passed through. In addition, higher oil product prices would lead to higher energy prices generally, and consumers would pay significantly higher prices for the energy they consume directly as well as for products whose production requires large amounts of energy. Moreover, the diversion of consumer spending to pay the new tax would reduce consumer outlays on some goods and services and would decrease the amount of personal saving available for new investment.

- There would be regional inequities from an oil tax. For example, consumers in areas of the country such as New England that utilize relatively large amounts of oil would bear a disproportionate share of the financial burden.
- The history of the Mandatory Oil Import Program in the 1960's and the price and allocation control programs of the 1970's demonstrates that requests for special treatment and exemption may well be granted to various classes of oil users. Thus, an oil tax likely would become administratively complex and create distortions in petroleum markets.
- Oil markets have been subject to considerable fluctuation and uncertainty in recent years. It would be unwise to commit the U.S. to a sizable contingent oil tax without

consideration of what the price of oil might be at that time, the size of U.S. oil imports, or the relationships with oil exporters many of whom are neighbors and allies.

- Even if the economy is expanding in mid-1985, there may nevertheless be substantial amounts of unemployed resources. In mid-1982 for example, the economy, as measured by inflation-adjusted gross national product, was expanding. Yet the nation was in a deep recession. Raising taxes in such a period probably would have significant contractionary effects which would exacerbate the problems of unemployment.

Oil Import Fees

Some have suggested that a substantial additional fee be placed on oil imports. Such a fee would have many undesirable consequences.

- Imposition of an oil import fee would prevent economic growth and employment which otherwise could have occurred with a drop in world oil prices. Secretary of the Treasury Regan, for example, has estimated that a 20 percent decline in the price of imported oil would boost the U.S. gross national product by about one percent and increase employment by about one-half million. A substantial import fee would partially or fully offset the OPEC price reductions, and hence it would deprive the U.S. economy of such benefits.

- An oil import fee would lead to higher energy prices generally. According to government and academic studies of such fees, the price of domestically produced oil would be bid up to the price of imported oil including the fee. While some argue this circumstance would be beneficial to domestic producers, the history of governmental attempts to impose fees, quotas, and other types of controls on imported crude suggests that such programs generally include numerous exceptions and biases which discriminate as among importers and importing regions. Accommodating these types of demands distorts the efficiency with which oil is imported and distributed and ultimately results in higher oil prices for consumers. Additionally, the prices of substitute energy sources such as natural gas and coal also would tend to rise. Industries that use energy intensively, including many such as steel and other metals which currently are extremely depressed, would be particularly hard-hit by increased production costs. Their ability to raise sales and employment from their currently depressed levels thus would be impaired.
- Inasmuch as an oil import fee would reduce economic growth and employment, there would be decreases in federal tax revenues which must be netted out from revenues collected under the fee. When these decreases

are taken into account, it is uncertain whether an oil import fee would contribute much towards reducing federal budget deficits.

- Like a tax on all oil use (discussed above), an oil import fee would reduce the competitiveness of much of U.S. industry, reduce overall economic efficiency, cause greater unemployment of resources in domestic oil refining and marketing, raise consumer costs for energy and for goods produced with large amounts of energy, and create regional inequities.
- It would not be consistent with a policy of free trade and could harm certain countries allied to the U.S. A sizable portion of U.S. oil imports comes from neighbors and allies such as Mexico, Canada and the United Kingdom. The U.S. is committed to reducing, not increasing, trade barriers under the General Agreement on Trade and Tariffs (GATT). A U.S. fee on oil might encourage retaliatory action on other traded goods.
- It would not be consistent with the President's Caribbean Basin Initiative which is intended to spur economic activity in that area, in part through reduced impediments to trade. However, if the Caribbean Basin were excluded from a sizable new import fee, the U.S. refining industry could be greatly harmed by the relatively low-cost competition.

Some might argue that presently falling oil prices offer an opportunity to increase taxes on oil without much affecting consumers. But whether oil prices are falling, stable or rising, new taxes will raise costs to oil consumers above what they otherwise would be. Further, events over the last decade or so indicate that oil markets can be highly volatile, with disruptions of one sort or another quickly changing the course of price movements. Nothing in the present pattern of falling oil prices is inconsistent with a rapid change should some disruptive event again occur.

The proponents of an import fee allege two basic advantages: (1) an import fee would stimulate domestic energy production; and (2) by discouraging domestic oil consumption and encouraging domestic energy production, an import fee would cut the demand for imported oil, thereby putting downward pressure on its price.

First, it is uncertain to what extent domestic energy developers would act on an import fee that might later be discontinued. Second, any increase in domestic energy production would be at a cost greater than the real cost of imported oil (the import cost excluding the import fee). And third, an import fee may not result in a cut in worldwide oil demand sufficient to cause a significant drop in oil prices in world markets. It appears imprudent, therefore, to impose on the U.S. economy all the disadvantages stated above when the benefits are highly uncertain.

## Conclusion

API believes that the imposition of any substantial new taxes at this time would adversely affect the national economy. We are concerned about the size of the federal deficits projected for the out-years. We believe that the main thrust of future deficit reduction should be serious efforts to reduce the growth of federal spending.

3/8/83

# STATEMENT OF
# COMMITTEE FOR EFFECTIVE CAPITAL RECOVERY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
WASHINGTON, D. C.
JUNE 28, 1983

INTRODUCTION

The Committee for Effective Capital Recovery is a voluntary coalition of 577 business firms and 54 business associations. It is representative of virtually all segments of industry including manufacturing, retail, minerals, transportation, and utilities. A list of the member companies and supporting associations is attached (see Appendix A).

Formerly called the Ad Hoc Committee for an Effective Investment Tax Credit, the Committee has long been active in efforts to improve, strengthen, and make permanent capital cost recovery allowances, devoting itself initially to the investment tax credit.

The Committee for Effective Capital Recovery vigorously believes that the capital recovery provisions provided by the Economic Recovery Tax Act of 1981 (ERTA) should not be further diluted and that the curtailments made by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) should be restored.

In any event, we do not believe that a tax increase is necessary at this time. Should the Congress ultimately determine that a tax increase is necessary to reduce our deficits and that serious consideration should be given to structural changes in our tax laws (e.g., a consumption-based tax), we would urge that the need to provide incentives to savings and investment be adequately reflected in such changes.

## I. ECONOMIC RECOVERY TAX ACT OF 1981

By 1981 the urgent need for improved capital recovery was acknowledged by virtually every member of Congress, by most economists, and by the general public. This focus on improved capital recovery was not surprising. At that time it had become clear that two of the most pressing economic problems facing this nation were its declining productivity and its loss of competitiveness with other nations. Both problems were in large part the result of the United States' tax system. Corporations were paying huge federal taxes on illusory profits -- profits that resulted solely from the impact of inflation. Such taxes led to reduced corporate cash flows and inadequate capital investments -- which have had a slow but seriously deleterious impact on the economic health of our nation and its ability to compete with other nations.

One of the important keys to economic recovery was believed to lie in increased savings and investment in plant and equipment. In 1979 business savings comprised approximately 76 percent of the total national savings, and capital recovery allowances accounted for approximately 88 percent of all business savings. Thus, if savings was to be increased, capital recovery allowances had to be improved.

In its 1981 deliberations, Congress considered a variety of competing proposals, all of which provided for some form of accelerated capital recovery. While Congress adopted the Accelerated Cost Recovery System (ACRS) or 10-5-3 proposal, it was only after considering and explicitly rejecting immediate expensing of capital investment in personal property as an alternative.

Under ACRS as originally enacted, the cost of eligible personal property is recovered over a 3-year, 5-year, or 10-year period depending upon the type of property involved. Cars, light-duty trucks, R&D equipment, and other short-lived property are in the 3-year class. Most other personal property is in the 5-year class as are single-purpose agricultural structures and petroleum storage facilities. Ten-year property includes certain public utility property and real property with a class life of 12-1/2 years or less. Other real property is placed in a separate 15-year real property class. Under ACRS, salvage value is not taken into account.

For personal property placed in service in 1981 through 1984, ERTA had provided a recovery method approximately equal to the benefit obtained by using a 150 percent declining-balance method for the early years, with a switch to the straight-line method for the remainder of the recovery period. This method had been scheduled to change (1) in 1985 to approximate the 175 percent declining-balance method, with a switch to the sum-of-the-years-digits method; and (2) in 1986 and thereafter, to approximate the 200 percent declining balance method, with a switch to the sum of-the-years-digits method.

Under ERTA, three-year recovery property was eligible for a six percent investment tax credit and five- and ten-year recovery property was eligible for a full ten percent investment tax credit.

Had these provisions been untampered with, we may well be further along the road to recovery than we are now. Unfortunately, in 1982 -- barely one year after ERTA was enacted -- the benefits provided by the ACRS provisions were significantly curtailed.

## II. TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

While ERTA was estimated to provide business tax cuts in excess of $150 billion over six years, TEFRA was designed to increase business taxes by in excess of $100 billion over six years. In large part, TEFRA's tax increase was achieved by limiting the capital recovery provisions, which limitation accounted for almost one-half of the $100 billion tax increase.

Essentially, TEFRA amended the capital recovery provisions by requiring a taxpayer to reduce the basis of his assets by 50 percent of the amount of investment tax credits, energy credits, and certified historic structure credits earned with respect to the property. Alternatively, taxpayer was given the option with respect to the regular investment tax credit on recovery property to elect a 2-percentage point reduction in the credit instead of the basis adjustment.

Additionally, TEFRA limited the use of the investment tax credit to only 85 percent of the regular tax liability, rather than 90 percent; and repealed the increased rates of recovery scheduled to go into effect in 1985 and 1986.

By enacting TEFRA a mere one-year after ERTA, it appears that the United States has again adopted the tragic on-again-off-again investment tax credit policy that prevailed through the 1970's. In so doing, it is unfortunate that the Congress ignored the ample evidence indicating the need to permit sufficient time to elapse before the full effect of such incentives can be measured.

## III. WHERE WE ARE TODAY

While our nation is now in the midst of an economic recovery, we must not jeopardize that recovery by adverse changes in our tax policy. The recovery has begun with interest rates already at very high levels -- rates which are starting to move up again. Money supply is growing faster than the guidelines the Federal Reserve has set for itself. And huge budget deficits continue to be projected into the future. Thus, despite the recovery, the danger of an increase in inflation has risen, which could bring with it a reversal of the recovery that we have thus far seen.

Nevertheless, and notwithstanding the TEFRA amendments, some in Congress would propose limiting the ACRS provisions further yet by requiring a basis adjustment of the full amount of investment tax credit claimed, rather than a basis adjustment of one-half of the investment tax credit claimed.

These critics base their proposal on the views of some in the economic community who argue that ACRS continues to provide too great a windfall to the business community. Essentially, these arguments run along two lines: first, that ACRS provides benefits greater than expensing; and second, that ACRS results in a misallocation of investment among assets. Each of these theories, however, is beside the point, and should not warrant any change of policy from that originally intended.

### A. ACRS Provides Greater Benefits Than Expensing

The argument that ACRS provides greater benefits than would be available under expensing is not new, but was offered well before ACRS was first enacted. While Congress rejected it in 1981 in enacting ERTA, the same argument surfaced again in the 1982 tax debates and apparently accounted for TEFRA's curtailment of the ERTA's capital recovery provisions. In this regard, the Staff of the Joint Committee on Taxation's General Explanation of TEFRA stated:

> Cost recovery deductions for most personal property allowed under ACRS, in combination with the regular investment tax credit, generated tax benefits which had a present value that was more generous than the tax benefits that would be available if the full cost of the investment could be deducted in the year when the investment was made; i.e., more generous than the tax benefits of expensing.

Even after the TEFRA amendments, however, some in the economic community maintain that ACRS continues to provide greater benefits than expensing. Essentially, these critics have noted that few corporations are subject to tax at a 46 percent marginal tax rate, but most are subject to federal tax at a lower rate. Therefore, these critics argue that the present value of the ACRS deductions and the investment tax credit should be compared with the present value of expensing using a marginal tax rate less than 46 percent. And their calculations show that, at marginal tax rates below 46 percent (with particular interest assumptions), ACRS with the investment tax credit is indeed more favorable than expensing.

In responding to this argument, it is important to recognize that these critics are ignoring the effect of other taxes on capital. At the federal level, dividends are taxed upon distribution to individual shareholders and the capital gains tax is paid upon the sale of their stock. In addition, state and local governments impose income and property taxes on corporations. The effect of these various levels of taxation is to increase the effective tax on an asset acquired by a corporation beyond the marginal federal income tax rate.

Moreover, while it is true that corporations are generally subject to a marginal federal tax rate below 46 percent, the effective marginal tax rate is not as low as some critics would have one believe. The U.S. Department of Treasury's *Statistics of Income*, *1980 Corporate Income Tax Returns* indicates a total corporate income subject to tax that year of $247 billion on which a U.S. tax of $63 billion was paid, for an effective U.S. tax rate on U.S. corporations' worldwide income of almost 26 percent. But the amount of U.S. taxes paid reflects a reduction of almost $25 billion (i.e., over 10 percent) due to foreign taxes paid. When U.S. taxes are increased by creditable foreign taxes, the 1980 effective tax rate on U.S. corporations was approximately 36 percent.

Assuming a marginal tax rate of 36 percent, which as indicated above understates the total tax burden on corporate investment, the following comparison of expensing versus ACRS (with the one-half ITC basis adjustment) may be made:

Present Value of ITC and Future Tax
Savings at Selected Discount Rates --
36% Assumed Tax Rate (per $100 cost)

| Expensing | 3-year (6% ITC) | | 5-year (10% ITC) | |
|---|---|---|---|---|
| | 12% | 16% | 12% | 16% |
| $36.00 | $36.88 | $35.77 | $37.23 | $35.52 |

At a 12 percent discount rate, ACRS provides a slight benefit over expensing. And at a 16 percent discount rate, ACRS is clearly less advantageous than expensing.

Thus, ACRS will provide greater benefits than expensing only at relatively modest interest rate assumptions. But the notion that our tax policy should be based on low and stable interest rates is not practical. Experience has shown that interest rates fluctuate. Businesses must be able to plan ahead with certainty and cannot be asked to face the risk of shifting tax policy based upon shifting interest or discount rates.

In any event, the assumption that benefits greater than those available under expensing is in some way inappropriate is itself subject to question. Other provisions of our tax Code may result in benefits greater than those available from current expensing (e.g., the R & D credit and the jobs credit), as may provisions in the tax laws of our trading partners. If a goal of our tax policy is to stimulate increased business investment -- and we believe that it should -- benefits greater than expensing are entirely appropriate.

## B. Misallocation of Capital

The second arguement that has been advanced against ACRS is that the capital recovery provisions, together with the investment tax credit, result in an inefficient allocation of investments among assets and among industries. Proponents of this position argue that the ACRS and investment tax credit rules tend to favor investment in short-term assets over long-term assets. This arguement is premised upon the assumption that it is best for society if the rate of return on different assets is not affected by the tax system.

Obviously, there is unlikely to be any capital recovery system that would be perfect in this respect. However, one economist, Jane Gravelle of the Congressional Research Service, has attempted to quantify what she terms as "inefficiencies" in investment allocation. These inefficiencies accrue from the potential of the tax law to modify the flow of capital between more or less productive assets.

She compared the inefficiencies existing under ERTA and TEFRA with those existing prior to ERTA. Her analysis considered the effect of tax policy on the allocation of capital both within the corporate sector and between the corporate and non-corporate sectors, thereby considering its total effect on economy-wide investment uses.

Her results are summarized in Table I on the next page.

### TABLE I

### ANNUAL INEFFICIENCY IN INVESTMENT ALLOCATION*
(Billions of Dollars)

| Sector | Pre-ERTA | ERTA** | Effect of ERTA*** | TEFRA | Effect of TEFRA*** | Combined Effect of ERTA and TEFRA*** |
|---|---|---|---|---|---|---|
| Intracorporate Only | 3.3 | 3.8 | + .5 | 1.5 | -2.3 | -1.8 |
| Economy-wide (Total) | 17.4 | 11.9 | -5.5 | 11.6 | - .3 | -5.8 |

---

*All estimates measure impact of relevant law if it had been implemented in 1980.

**Refers to the 1986 depreciation schedule provided in ERTA.

***Positive numbers in the column reflects additional inefficiency, while negative numbers reflect a reduction in inefficiency.

Source:

Figures obtained from statement of Jane Gravelle made at the Annual Symposium of the National Tax Association to be published in the forthcoming September 1983 issue of the National Tax Journal. The study assumes Cobb-Douglas production functions, unitary price elasticities of demand for each type of labor, capital and final output, and exponential depreciation. Consumer durables, housing, and inventories are included as investments in non-corporate sector; education, gold, collectibles and other investments are excluded. See source for assumptions on investment financing, personal tax rates, and other items. State and local taxes are not considered.

She found that tax law previous to ERTA caused an inefficiency or distortion in the allocation of corporate investment in 1980 in the amount by $3.3 billion per year relative to what might be considered an "optimum" allocation.

She estimated that under ERTA this inefficiency would have been $3.8 billion per year, or an increase of $.5 billion over the pre-ERTA level.

However, when she considered the improvement in efficiency caused by ERTA's lowering of effective corporate tax burdens relative to non-corporate taxes, this caused a net gain of $5.5 billion per year in the efficiency of total or economy-wide allocation of investment.

Accordingly, her work on balance contradicts claims of some critics that ERTA interfered with efficient flow of investment between alternative uses.

In the case of TEFRA, while the tax changes increased "efficiency" of capital ($2.3 billion), the overall effect was not statistically significant ($.3 billion).

Thus, contrary to popular impression, ERTA improved the allocation of investment in the economy while TEFRA had little or no effect on allocation.

In contrast, these tax changes have had a large and favorable impact on the level of investment, a far more significant factor. Allen Sinai, Andrew Lin, and Russell Robins at Data Resources, Inc. have analyzed the combined impact of ERTA and TEFRA. They estimate that they will increase 1985 investment in plant and equipment by $17 billion relative to the amount which would occur under pre-ERTA legislation.

Certainly there seems little justification at present on allocation grounds to further curtail the capital recovery provisions of ERTA.

## IV. WHERE DO WE GO FROM HERE

ERTA was proposed and enacted as a multi-year tax act. Both the Administration and the Congress promoted the need for a multi-year act to provide a stable tax environment for business. Without such a stable tax environment, American business is unable to make intelligent investment decisions. With the enactment of ERTA, many companies commenced planning major capital investments to be placed in service in future years. These investments were initiated, in large part, as a result of the commitment made by the Administration and Congress that the tax package enacted in 1981 would continue in place. The modifications made in TEFRA undoubtedly made some of these investments financially impossible, as they adversely altered the projected rate of return available from such investments. The further erosion of ERTA's capital cost recovery provisions would frustrate our national goal of stimulating corporate savings and investment, and thus the Committee would vigorously oppose any such propoals.

Moreover, the Committee for Effective Capital Recovery joins those groups in opposing any tax incrase this year or next. While the outyear deficits remain a serious problem, we believe that dealing with them via a tax increase would, at this time, jeopardize the continuation of the recovery we are now experiencing.

Further, if the Congress considers major structural changes in our tax laws, we would urge that attention be given to a method of taxation which rewards savings and investment. Our tax laws are unique among industrial countries, as most derive a major portion of their revenues from consumption taxes or other methods of avoiding our present bias against savings and investment. And these countries generally have higher levels of personl savings, capital formation, and productivity growth than does the United States. Thus, at an early time, careful consideration of a consumption tax for the United States may be necessary.

## Statement of D. Michael Murray, Legislative Counsel on behalf of the Iron Ore Lessors Association, Inc. for the record of the Senate Finance Committee, June 28, 1983 hearing on Tax Expenditures.

1

In 1963, after extensive debates in both the Senate Finance Committee and in the Committee on Ways and Means, Congress enacted legislation (U.S. Code 631 (c)) that treated the sale of iron ore as that of a capital asset, and therefore taxable as a capital gain rather than as regular earned income.

Fair taxation of the proceeds given to a landowner from the sale of iron ore has been a problem due to the peculiar nature of the investment. Once iron ore lands are purchased, they often lay undeveloped, sometimes for decades before an operator begins mining, and only then do they show a return on investment. Historically, landowners have been taxed at the maximum earned income rate due to the scale of such activities. This has been recognized as inequitable as applied to this category of landowner. It is also poor public policy to hinder the development of American iron ore reserves and directly contribute to the increased costs of domestic steel. The legitimacy of this problem was finally acknowledged by Congress and remedied.

Not only did the capital gains treatment contribute to the solutions of the problems facing the iron ore and steel industries, it is the proper theoretical treatment for the sale.

Iron ore property is purchased as an investment, just as one would buy stock or any other capital asset. The only difference between iron ore and most other capital assets, and one that weighs more in favor of the present tax classification, is that it is only disposed of gradually over an extremely long period of time. In some cases, the lands may not be touched for over half of a century.

This proper sales classification has unquestionably stimulated and produced, indirectly, considerably more revenue than the comparatively small amount of tax directly attributed to disposal contracts. The Joint Committee on Taxation estimates the Federal Tax Expenditure for the iron ore industry to be $10 million dollars in 1983 with no increase for the period through 1987.

For the following reasons, we consider any change in the present tax classification most inequitable and ill-advised and urge that the capital gains treatment be retained for iron ore classifications.

## Damage to U.S. Steel Companies

Increased costs related to domestic iron ore will also worsen the competitive position of the U.S. steel industry. Many U.S. Steel producers have invested millions dollars to develop iron ore lands. The investment includes the actual mines, pellatizing plants, railroads, dock facilities, and often even container fleets. Because of the size of these investments these companies literally cannot afford not to use them. To shift to lower cost imported ore would be the equivalent of writing off billions of dollars of investment (not to mention thousands of jobs). Therefore, these steel companies must use this ore and any increase in cost in producing it must either be reflected in higher steel prices or lowered profits. This is hardly what the industry needs at this time.

## The Inflation Penalty

To tax royalties paid upon the removal of iron ore from the land as regular income ignores the effect of inflation over the very long holding period for iron ore lands. Iron ore lands are not the type of assets that are constantly being turned over by speculators seeking to turn regular income into capital gains.

An investment in iron ore lands may not see any income for decades, and then the return will be spaced over decades more. In fact, several members of the Iron Ore Lessors have been developing the same lands for almost a century. To tax this income at regular earned income rates would be most unfair to the holders of this type of asset.

## Higher Domestic Iron Ore Prices

### More Imported Foreign Ore

Should the earned income tax rate be imposed on the sale of iron ore, the owners would be forced to raise their prices when leases are renegotiated, to compensate for the increased tax. Such a price increase would damage an already weakened domestic iron ore industry and encourage increased imports of foreign ore. It should be noted that most of these imports come from nations with government controlled mining companies. Besides not paying comparable wages or employing the environmental safeguards that U.S. producers employ, these nations are chiefly interested in iron ore as a source of foreign currency. Therefore, they will consistently undercut U.S. prices.

If the domestic price of iron ore cannot rise enough to meet some of the increased costs of the tax increase, an option open to some owners is to withdraw all or most ore from the market and await higher prices. This could trigger massive unemployment in the iron fields.

Currently the iron ore industry is operating at roughly 31 percent of its aggregate national capacity, a rate which approximates that of the Great Depression. The unemployment situation in the iron ore industry is at a crisis stage. Unemployment in the industry is running at about 11,300; thus, it is an industry with over two-thirds of its workforce laid off.

It is clearly evident that the economic condition of the United States steel industry has reached a crisis stage. The outlook for improvement is quite dim due to increased foreign competition. Repeal of or alteration of the capital gains tax on iron ore would be very detrimental to an industry that is trying to remain solvent. This critical industry should not be penalized by the tax code at a time when its very survival is so questionable.

I believe that without a tax policy that encourages the proper management of our iron ore resources, the needs of our steel industries will not be met. The current economic situation of this industry clearly demonstrates the continued need for iron ore capital gains treatment.

# STATEMENT

BY

THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

TO

THE SENATE COMMITTEE ON FINANCE

HEARINGS ON TAX EXPENDITURES

JUNE 28-29, 1983

The National Association of Life Underwriters wishes to share with the Senate Finance Committee its views on tax expenditure revision as a means of generating new Federal revenues. NALU is a federation of state and local life underwriter associations representing 130,000 professionals who sell and service life and health insurance and employee benefit plans in virtually every community in the United States.

Under the 1983 first concurrent budget resolution, Congress must generate $73 billion in new revenues over Fiscal Years 1984-1986. Means of accomplishing this task include imposition of new income or excise taxes, improved compliance provisions, base-broadening via streamlining of the tax expenditure budget, or a combination of some or all of these options.

These hearings focus on the possibility of generating new revenue via examination and reduction of federal tax expenditures. While on the surface a reduction in tax expenditures appears to be the least noxious way of going about the unpleasant task of raising substantial amounts of new federal revenue, the complications of definition and measurement, the policy behind each provision, the potential shifts in behavior, and the experience of last year's omnibus tax bill (The Tax Equity and Fiscal Responsibility Act of 1982) bespeak caution before proceeding.

Tax expenditures--the amount of otherwise collectible income tax foregone because of special exemptions, deferrals and deductions in the tax code--are historical means of encouraging specific behavior by America's taxpayers. Where a tax expenditure provision works, i.e., where the behavior achieves desired results, Congress should move slowly before denying that encouragement solely for the purpose of generating new revenue.

Not only does such denial raise the potential of discouraging behavior thought to be desirable, it also raises questions about whether, absent the behavior on which the tax expenditure provision is based, new federal revenues will result. The danger, then is double-edged. Reckless revision of the tax expenditure budget threatens both policy and revenue.

For example, one tax expenditure being considered for possible limitation is the provision allowing employers to provide group health insurance to their employees, without the value of that insurance being counted as taxable income to employees. The revenue estimates connected to the proposed limits on this provision are temptingly large: $2.7 billion in 1984 and up to $30 billion by the end of the decade. However, a closer look shows that those numbers are slippery, at best. They are predicated on an assumption that employers will continue to provide health insurance at current projected levels. They ignore the incentive inherent in the tax expenditure provision to encourage provision of health insurance. Removal of the incentive is more likely to result in a cut-back in employer-provided insurance. In turn, this means an increase in underinsured (or coverage of only the most expensive forms of health care delivery, like hospital coverage) and little or no increase in employees' taxable incomes, and thus little or no new federal revenue.

In other words, this single tax expenditure, together with market forces, has resulted in widespread health coverage for America's workers. Cost pressures have led to increasingly efficient coverages, too, thus encouraging provision of quality health care in a cost-efficient manner. To undo this, to get the appearance of $2.7 billion in new revenue in FY '84, risks the health--physical and economic--of our nation's employees. Worse, the risk carries with it little, if any, likelihood of significant new revenues for the Federal treasury.

This particular tax expenditure was the subject of its own day of hearings before this committee, on June 22, 1983. The policy and revenues connected to it were discussed exhaustively there. For now, suffice to say that the policy underlying this provision deserves careful consideration before Congress makes any changes to it. At a minimum, it should be examined thoroughly not only by Congress' tax-writing committees, but also by the committees having jurisdiction over its substantive elements.

This example graphically illustrates the complexities of defining, measuring and predicting tax expenditures. There are many, many more such examples, including the so-called inside buildup of permanent life insurance, pensions, the deduction for interest on consumer loans and others.

In the case of life insurance tax provisions, including the inside buildup and pensions, the same general cautions apply. Both are proven, effective means of encouraging socially-desirable behavior (planning for financial security in the case of premature death and/or retirement). Both carry large revenue figures. (In FY'84, $60 billion for pensions; $5 billion for the inside buildup.) Both figures, though, are as misleading on the surface as the figure attributed to the health insurance tax expenditure.

For example, consider the potential effect of limiting or eliminating the exclusion from current income of the cash values in a permanent life insurance policy. First, it is not at all clear that the inside buildup is indeed "income, from whatever source derived" in the year it is credited to a policyholder, thus illustrating the definitional problem. Cash value in a permanent policy is first and foremost an incident of the reserve required by law maintained to support the contract's guarantee of payment at death or maturity of the policy. To tax that value, prior to surrender of the policy, is in reality to tax an unrealized death benefit. Generally, those values are obtainable by the policyholder only as a loan against a future interest, repayable with interest. To tax this unrealized future interest would be patently unfair.

Further, current tax liability on cash values would discourage purchase of permanent life insurance. That, in turn, imperils the financial security of millions. This is so because people are then more likely to buy term insurance. But, fewer than 1% of all term policies result in a death claim. In other words, very few people, relatively speaking, actually die while owning term insurance. Stated another way, the vast majority of death claims are on permanent policies.

The result of a substantial decrease in permanent life insurance coverage would be large-scale financial insecurity, especially at or after retirement, and again, no more federal revenues. Taxes won't be paid on values not earned and values won't be earned if permanent insurance is not purchased.

Further, consider the tangential effect on tax revenues collected from insurance companies! Term policies require much lower reserves to maintain than permanent policies. Lower reserves mean fewer dollars to invest, leading to lower earnings by companies, leading to lower tax collections.

But perhaps most importantly, this committee should remember that this provision, like so many others, is the subject of Congressional scrutiny in another forum. The House of Representatives' Ways & Means Committee's Subcommittee on Select Revenue Measures has already done substantial work on a new tax structure for life insurance. There, policy as well as revenue is being carefully considered. It is simply inappropriate to consider the same subject here in the misleadingly narrow context of the need to generate a fixed amount of new revenue over a finite period of time. This is particularly true in light of the fact that this committee also has jurisdiction over the life insurance tax bill, and is now working with the House subcommittee to fashion appropriate legislation.

The same arguments support restraint in the area of pensions. Both this committee's Subcommittee on Savings, Pension and Investment Policy and the Labor Subcommittee of the Senate's Labor and Human Resources Committee have held hearings, in April, May and June of this year on the subject of pension reform. While the size of the tax subsidy, assuming its measurement is even somewhat accurate, is huge, it must be judged in the context of its results. To do otherwise risks unbelievable costs to the Federal government, in the form of welfare to retirees who would not have the pensions now possible at least in part because of the tax incentive to provide them and due to increased pressure on the financially volatile Social Security system.

Further, pension incentives have already been substantially reduced by the provisions enacted in TEFRA. Early evidence was presented by the pension industry at a hearing April 11, 1983 before this committee's Subcommittee on Savings, Pension and Investment Policy, and again May 24 before the Senate's Labor and Human Resources Committee's Subcommittee on Labor. That evidence indicates that TEFRA's pension provisions, enacted hastily and in an effort to raise revenue rather than to achieve overall pension law reform, will cause the termination of thousands of pension plans. Those same early indications show that far fewer new pension plans are being set up. And TEFRA's pension rules are largely prospective. Most of them don't go into effect until 1984. To enact yet another round of pension plan restrictions in the name of revenue raising flirts with the possibility of devastating the nation's private pension system. The economic cost, in terms of lost capital and inadequate retirement planning by millions of workers, is hardly worth the temptation to gain illusory revenue from a tax incentive that has resulted in a vital, healthy private retirement system.

The possibility of repealing, or limiting, the deduction for interest on consumer loans has similar troublesome aspects. Again, this provision is a tempting revenue target. The Joint Committee on Taxation estimates it will cost the Federal Treasury $8.1 billion in 1984. However, its implications are far broader than its revenue impact.

From an insurance viewpoint, the provision is important because it allows the deduction of interest on life insurance policy loans (assuming IRC Section 264's so-called "Four-out-of-Seven" rule is met). And the ability to deduct policy loan interest is considered by life underwriters an important sales tool. It adds to the factors leading to a decision to buy permanent insurance rather than term. A minority of policies are systematically borrowed against. Yet, policy loans are often the sole means of continuing permanent insurance contracts during the temporary lean times that hit nearly all of us. Loss of that permanent protection bodes ill for the financial security of policyholders whose permanent insurance provides a significant portion of planned retirement income, as well as for the beneficiaries of insureds who die "too soon."

In conclusion, most--if not all--individual tax expenditure provisions are grounded in policy and have resulted in social behavior that in turn has generated economic benefit to the U.S. government. It would be extremely unwise to change those decisions without recognizing the tremendous social and economic impact those changes could cause. The tax expenditure budget, and the policy it represents, should be reviewed in light of social policy and overall economic impact. To review tax expenditures only as a means of raising short-run revenues would be misguided at best. The experience of TEFRA confirms this. Thus, this committee should exercise extreme caution in focusing

# Statement of D. Michael Murray, Legislative Counsel on behalf of the National Council of Coal Lessors, Inc. for the record of the Senate Finance Committee June 28, 1983 hearing on Tax Expenditures.

In 1951, after thorough consideration and extended debate, Congress enacted legislation that classified contracts which dispose of coal in place as sales, making the net proceeds capital gain or loss, under U.S. Code 631 (c).

Fair taxation of proceeds given to a landowner from the sale of coal has been a problem since the income tax was first instituted. The problem stems from the peculiar nature of the investment. After coal lands are first purchased they may lie undeveloped for decades, only showing a return on investment when an operator is persuaded to begin mining. Once this mining begins; however, it is inevitably on such a scale that the proceeds to the landowners would be taxed at the maximum rates. Therefore, there is really no graduated income tax for owners of coal lands, only the maximum tax.

This was no great problem when the income tax was first instituted. At that time the maximum rate was only 7 percent. But when the rates soared, particularly during the war years and early 1950's, this maximum taxation was recognized as inequitable. Not only did it grossly overtax coal landowners, it was poor public policy since it was hindering the development of United States coal reserves and directly contributing to the increasing costs of domestic energy. The legitimacy of this problem was recognized by Congress and remedied.

Not only does the capital gains treatment contribute to the solutions of the problems facing the coal and steel industries, it is the proper theoretical treatment for the sale of coal. Coal property is purchased as an investment, much the same as one would buy stock or any other capital asset. The only difference between coal and most other capital assets, one that weighs even more in favor of the present tax treatment, is that it is only disposed of very gradually over an extraordinarily long period of time. In some cases, coal lands may not be touched for over half of a century. It is hardly the type of investment that would be made by a speculator trying to manage a quick shift from regular to capital gains status.

For the following reasons, we would consider any change in the present tax structure most inequitable and ill-advised and urge that the capital gains treatment be retained for coal.

"The fact that coal is a nonrenewable resource would dictate the policy of efficient development and management of coal lands so that American energy self-sufficiency is not compromised. Any change in the present tax structure would conflict with Administration and Congressional policies to promote healthy American business activity while reducing unemployment and curbing foreign business infiltration."

Such coal contract dispositions are, in essence, sales of coal with a retention of an economic interest. The payments; therefore, are treated as proceeds of a sale and not as rent. Many long-term contracts that range from 20 to 60 years have been executed in reliance of capital gains treatment of gains realized on royalties. The Lessors, under these contracts, would suffer severe and unjust financial hardship if a change in tax classification were to be made before the contracts were complete.

The loss to the Treasury Department on capital gains treatment of money received for disposition is relatively small. This is because a substantial percentage of the coal property is owned by corporations which distribute income as dividends, taxable as ordinary earned income. The Joint Committee on Taxation's 1984-1985 estimated federal tax expenditure figures for the coal industry did not take into consideration the severe economic conditions in the coal industry. Because of the current economic conditions, royalty payments on coal will be extremely low, if non-existent.

There is no doubt that coal pays its fair share of taxes. State severance and gross receipts taxes generally result in lower royalties for Coal Lessors. Land companies that made a profit paid an effective Federal tax rate of 34% in 1980, which is a much higher percentage than most major industries.

A change in the sales classification would result in higher domestic coal prices, which would increase energy costs and in turn, cause steel prices to soar; thus inviting more foreign imports which already threaten the survivors of the industry.

Currently, the coal industry is experiencing economic hardship. Presently, capacity utilization is at 67 percent. Metallargical coal, which is crucial to steel production, is now operating at only 48 percent of capacity. In the first quarter of 1983, the unemployment level in the coal industry was at 75,000--compared with 40,000 unemployed in July of last year. This brings the national unemployment rate for this depressed industry to 31.6 percent.

It is essential for the development of the coal industry, for the survival of the steel industry, and for a form of cheaper energy for consumers, that this committee preserve the capital gains tax for coal.

**National Governors' Association**

**Scott M. Matheson**
Governor of Utah
Chairman

**Raymond C. Scheppach**
Executive Director

July 7, 1983

The Honorable Robert Dole
Chairman
Senate Finance Committee
United States Senate
Room SD-221
Washington, D.C. 20510

Dear Mr. Chairman:

We regret that we were not able to participate in the hearings on tax expenditures you held at the end of last month. The Governors' policy on the FY 1984 budget recognized that tax increases might be necessary, in order to reduce the deficit, and we want to be helpful to you in this difficult process. We do support a limit on the tax-exemption of employer contributions to health insurance plans, as we have indicated in testimony before your Committee. However, the June 28-29 hearings happen to fall right at the end of the fiscal years of many states, and Governors with whom we discussed the hearing found they needed to stay at home to attend to last minute fiscal issues. Although NGA was not able to appear at the hearing, we wish to provide input for your deliberations.

The key point we would like to convey is the importance of performing an intergovernmental review of any tax provisions the Committee is considering this year. You are well aware of the close fiscal relationship between the federal and state governments. Not only do the two levels of government participate jointly in spending programs—such as Medicaid and AFDC—but federal tax decisions affect the tax resources available to state government, the cost of state taxes, important economic development and housing initiatives, and in some cases directly raise or lower the revenues collected by states.

In past years, major federal tax decisions have been made without reference to the impact they will have on state and local governments. Where this lack of coordination has created serious dislocations in the past, this year it would create fiscal havoc. State governments are taking extraordinary measures to maintain the balanced budgets that by law they are required to have. In FY 1983, 47 states took some step to close the gap between expected revenues and projected expenditures, including hiring limits, program reductions, and travel restrictions. Thirty-three states raised taxes on a temporary or permanent basis. Even after these extraordinary measures, the aggregate state balance is expected to be a razor-thin .2 percent—well below the 5 percent balance many experts believe to be necessary to absorb fiscal demands resulting from natural disasters, economic downturn, court orders and other unforeseen events.

Accordingly, we urge that you share with us as early in the process as possible any revenue proposals you are considering that will affect state governments. We look forward to working closely with you on this year's tax package.

Sincerely,

Governor Scott Matheson
Chairman

NATIONAL MULTI HOUSING COUNCIL

Mr. Chairman and Members of the Finance Committee

My name is Stephen Driesler. I am Executive Vice President of the National Multi Housing Council. The National Multi Housing Council (NMHC) is a non-profit organization with over 5,000 members representing all aspects of the multifamily housing industry. NMHC members consist of many of the nation's largest builders, developers, syndicators and managers of rental housing. In fact, I think it would be accurate to say that NMHC's members build, own or operate more apartment units than any other real estate group in the country today. In addition, our members primarily build and operate rental housing without direct government subsidies.

The flow of investment capital into rental housing today is strongly dependent upon incentives contained in the tax laws, particularly those providing for accelerated cost recovery. Without each and every advantage residential rental housing now has in the tax code, the apartment industry would be unable to effectively compete in today's capital markets.

The simple fact is that with today's high cost of land, materials and money, market rents generally do not create an income stream which is competitive with other types of investments. Add to this the level of risk associated with any real estate venture and you find that we in the rental housing industry are at a competitive disadvantage compared to the rate of return an investor can get with a money market certificate or other "no risk" investments. Thus, Congress has consistently recognized that tax incentives were a necessary and desirable means of enhancing the attractiveness of investments in rental housing.

This sound policy is beginning to succeed. For the first time since the mid-1970's, the production of unsubsidized rental is showing significant increases. Reduced interest rates, particularly those available in the tax-exempt market, combined with the tax incentives provided by ACRS, are making rental housing financially feasible without the need for direct federal subsidy. As a result, there is some hope that the crisis in rental housing, which worsened steadily over the past several years, will begin to abate.

It is essential that these tax incentives to rental production be preserved.

During the past few years Congress and the Administration have either eliminated or drastically reduced federal rental housing programs. This is especially true in the area of new construction. Therefore whatever new rental housing there is to be built in this country, in the foreseeable future, will depend upon private investment. If, however, the private sector can not attract sufficient capital to build or maintain apartments who will meet the housing needs of America's renters? The answer is no one.

These points were underscored by a recently published study by the Department of Housing and Urban Development entitled "Tax Incentives and Multi Housing" which according to Secretary Samuel Pierce, "documents the close and significant relationship between federal tax and housing policies."

The HUD study noted that the ACRS system enacted as part of the Economic Recovery Tax Act (ERTA) has produced net benefits for rental housing. It further concluded that the ultimate beneficiary of this tax advantage given is the consumer. After careful analysis of the competitive nature of the rental housing market HUD found "It is likely that most of the benefits to owners and investors under ERTA will accrue to tenants in the form of lower rents than would be the case without ERTA." (p. vi)

"Owners of rental property may benefit by themselves in the short run from a favorable change in rental tax provision. However, an enhanced rate of return will attract more investment and lead to lower rents than would be obtained in the absence of the favorable change. Since renters have lower incomes than other households, tax benefits that lead to decreased rents tend to be progressive in nature." (p. v)

Obviously, the converse of this finding is equally true. Any changes in the tax code which would reduce the flow of capital into rental housing or drive up its costs would ultimately result in higher rents and shortages of affordable housing and would be regressive in nature.

Another point, also emphasized by the HUD study, is that rental housing was not the primary beneficiary of the ACRS provisions of ERTA. While new rental housing received slightly more favorable treatment, commercial property improved its position significantly, and machinery and equipment even more. As the HUD study pointed out: "Notwithstanding, the favorable treatment of rental housing under the 1981 (Tax) law, there could be a flow of some investment capital out of rental housing and into construction of office buildings, shopping centers and other non-residential buildings...this potential movement of investment capital away from rental housing could be reinforced by the substantially more attractive tax allowance than were available under the previous Code for machinery and equipment. The simplified and spruced-up capital recovery system and increased investment tax credit favored non-residential investments."

A similar conclusion, that residential real estate came out of the '81 tax act as a competitive disadvantage, was reached by Jane Gravelle, Specialist in Taxation for the Library of Congress. In her study called the "Effects of the Accelerated Cost Recovery System by Asset Type", Ms. Gravelle found "there may well be a shift in the composition of capital towards business equipment and away from structures, particularly away from residential structures. The relative (and perhaps absolute) size of the housing stock could fall."

While it is too early to tell whether any such shift will occur, and while high demand and recent improvements in interest rates would tend to offset the unfavorable aspects of ACRS for rental housing in the short run, it is clear that to put rentals at a further disadvantage in the capital markets by cutting back on the available tax benefits would have potentially devastating consequences.

An additional point to be considered is the importance of predictability and consistency in tax treatment. Real estate investment by its very nature is a long-term proposition. To build an apartment complex usually takes several years from the time the project is first conceived until it is built and occupied. Apartments almost never generate a positive cash flow until they have been operating for many years.

Typically when people invest in real estate they are looking from five to ten years down the road before they expect to realize any real profit from their investment.

No one knows what inflation or other economic factors are going to be that far in the future and that is part of the risk any real estate investor takes. Nevertheless, the investor must base his decision on the tax laws of today. If an investor does not have some degree of confidence that the tax law is going to remain the same for at least a reasonable period of time, then this uncertainty multiplies his risks and reduces the likelihood he will make such a long-term investment.

In summary, the ACRS changes have only been in place for about two years and they are beginning to work in the residential real estate field; new construction of apartments is up, as is investor interest.

To change these incentives now would cause a substantial reduction in rental construction and threaten to stifle the economic recovery which they have helped to produce. Further, reductions in tax incentives for rental housing would aggravate the shortfall in the number of units needed to meet present and future rental housing requirements. Thus, ultimately resulting in higher rents to tenants.

Finally, any reduction in tax incentives for rental housing would cause great uncertainty on the part of investors, owners and developers and would be unfair to those who have entered into economic relationships based on the current 15 year cost recovery schedule.

# STATEMENT TO THE

# COMMITTEE ON FINANCE
# U.S. SENATE

ON

# TAX EXPENDITURES FOR SOLID WASTE DISPOSAL FACILITIES

SUBMITTED BY

Michael Cooper
Director, Technology Programs
NATIONAL SOLID WASTES MANAGEMENT ASSOCIATION

June 28, 1983

Good morning Mr. Chairman and members of the Committee. My name is Michael Cooper, Director of Technology Programs of the NATIONAL SOLID WASTES MANAGEMENT ASSOCIATION. Our members provide waste collection and landfill disposal services. They also provide complete resource recovery services including systems design, construction and operation. All these systems can help meet the national need for environmentally safe waste disposal and energy development.

Communities have two basic choices in refuse disposal: either bury it in the land or burn it. Where economics allow, disposal by incineration with energy recovery best serves the public purpose intended by Congress. Restrictions on the use of tax incentives, or tax expenditures, would mandate a continuation of refuse disposal in landfills. Our members will also meet that mandate.

Last year we provided testimony to this Committee showing that communities would be able to finance waste-to-energy projects through private sector participation because the overall costs to the community would be significantly lower. At that time we believed elimination of tax incentives to attract private investors to participate in these projects was a bad idea. The Congress agreed that these projects indeed served a strong public purpose and exempted solid waste disposal facilities from restrictions placed on industrial development bonds through the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982.

We come to you today to report our experience of the past twelve months. Your judgment of last year was sound. Since then we have seen five projects financed and construction begin, four financed using the special provisions provided and intended for use by the Congress through TEFRA. Our members have told us that they would not have invested in these projects in this manner had investment incentives not been available. These projects would not be under construction today had these investment incentives not been available. Eventually they would have been built but the cost to those communities would have been significantly higher.

The public purpose of the solid waste disposal exemption for IDB's which you crafted last year is being achieved. We perceive this purpose to be: First, the commitment expressed by Subtitle D of RCRA in 1976 to provide for environmentally sound solid waste disposal facilities and; second, the commitment expressed by the Energy Security Act of 1978 to seek energy independence. Prompted by these initiatives, we are now seeing a definite move at the state and local levels to develop adequate facilities for disposal of solid waste. Currently, more than two hundred communities are planning waste-to-energy projects which will help solve their disposal problems and provide for an energy component to help off-set disposal costs. Approximately twenty major projects are under construction or in operation. At least a dozen more are approaching the contractor selection and financing stage. The continued availability of tax incentives for resource recovery, the policy clearly emphasized by this Committee and the Congress last year, is directly responsible for the progress being made.

Solid waste disposal facilities today represent a unique partnership between the private sector and the public sector at the local, state and federal levels. Let me explain this relationship because it is key to why I am here today.

The local community has a responsibility to ensure that solid waste disposal occurs in an environmentally safe and cost effective manner. The environmental standards are established by state and federal regulatory agencies. However, about three-fourths of all refuse collection is performed by the private sector. Both collection and disposal costs are increasing due to rising energy prices for transportation and rising construction costs to make landfills environmentally safe. Today, private companies are usually able to finance landfill site acquisition and construction costs. This is not true for major resource recovery facilities whose costs can approach $250 million.

Rising costs and the inability to find long-term environmentally safe areas for landfill within their boundaries have moved many communities to examine disposal alternatives which may be economical in the long run. Most alternatives being examined today center around a waste-to-energy facility of some type. The facilities now being examined and built have the objective of reliable day-in, day-out disposal of solid waste. Financing these facilities, however, has proven to be difficult.

Communities have three generally available alternatives to financing a project: General obligation bonds; industrial development bonds; or industrial development bonds with private sector participation. Two communities have financed their facilities, one about three years ago and one recently, using revenue bonds with no private sector participation. Four others have selected and obtained private sector participants. It is this ability to choose from a variety of financing alternatives that must be retained for municipality use.

A major problem for many communities is that they are absolutely limited in the amount of debt they can incur. Their capacity is limited under the best of circumstances and the past few years have been far from good for the financial condition of many local governments. It is also unrealistic to assume that communities will be able to pay for a project simply by passing through the increased costs to residential and commercial waste generators. The pass through costs, generally in the form of increased dumping fees, stop projects when they are no longer competitive with landfills. Energy revenues under the best of circumstances in the first few years are insufficient to lower these costs to competitive levels.

In order for local officials and the taxpayers to make the decision to invest in what may be the largest single capital project for their community, disposal fees must be reasonable and competitive with other disposal options. If they are not, the community will continue land disposal. The four private/public sector projects financed have shown without question that the private investments have been used to lower the disposal fees to acceptable levels.

Adoption of restrictions on the use of tax incentives such as H.R. 1635 and 3110 would bring an abrupt halt to the timely development of future projects at the precise point that these first projects are struggling to their feet with the aid of these legislated incentives.

I would like to point out that the four projects, (Westchester County, New York; Baltimore County, Maryland; North Andover, Massachusetts; and Lawrence and Haverhill, Massachusetts), have other very definite public purpose fall-outs in which the private sector plays a part. First, the developer, the operator and the equity participant all have a large interest in making the project work. This interest was absent in several previous and on-going waste-to-energy projects with very unfortunate results. This interest assures the community needing the service that the project will dispose of their garbage reliably and in an environmentally safe manner which is the objective of the project in the first place. There is one entity responsible to the community for the project.

Second, the availability of tax incentives or tax expenditures which are used to attract private investors represents the appropriate federal commitment and participation towards achieving the twin objectives of effective treatment and disposal of solid waste and recovery of energy, commitments which Congress established in the Solid Waste Disposal Act and the Energy Security Act. Eliminating these incentives would essentially countermand the federal commitment to these objectives.

Please recall that we vigorously opposed and continue to oppose the use of federal grants, loan guarantees, price support loans and other similar instruments to assist resource recovery projects. We believe they encourage and reward adventurers who competed for projects against legitimate private-sector corporations possessing the technical and financial basis to complete a project and make it work. Communities also contributed to the problem by lining up, hoping for federal funds and delaying the solving of their solid waste problems. We are pleased that these programs are for the most part unfunded by Congress.

Solid waste disposal projects are self-limiting. They will only be built where there is a solid waste disposal problem. The energy recovery portion simply reduces the disposal costs and in the long run can make them economical for the community.

I would like to make one last point. These projects create new jobs. It typically takes 3-4 years to build and place into operation a waste-to-energy facility. The construction contractor will employ up to 200 workers during this period. When completed, these facilities will employ 60-70 full-time staff. They will commence returning taxes to the Treasury as soon as construction begins. They will still require a landfill and its employees for residue and shutdown periods. They will still require all of the collection personnel, both private sector or public sector to bring the refuse to the facility. And they will solve part of the solid waste disposal problem.

We believe that elimination of existing tax incentives would be a severe setback for municipalities attempting to make environmentally desirable choices about waste disposal, and in effect would be a de facto mandate by Congress for long term reliance on landfills, an exact reversal of our present policy.

On behalf of NSWMA, I want to thank the Committee for the opportunity to present the statement.

# Testimony to the Committee on Finance
# U.S. Senate

## on the subject of
## Tax Expenditures

on behalf of

American Association of State Colleges and Universities

American Council on Education

Association of American Universities

Association of Catholic Colleges and Universities

Association of Jesuit Colleges and Universities

Council of Independent Colleges

National Association of College and University Business Officers

National Association of Independent Colleges and Universities

National Association of Schools and Colleges of United Methodist Church

National Association of State Universities and Land-Grant Colleges

July 15, 1983

On behalf of the National Association of Independent Colleges and Universities, as well as the undersigned higher education associations, we would like to express our concerns about certain parts of the Treasury Department's tax expenditure list. We ask that this statement be made a part of the record of the Senate Finance Committee hearing on tax expenditures (June 28 and 29, 1983).

The Treasury Department prepared the first list of tax expenditures in 1968 when Professor Stanley Surrey was Assistant Secretary for Tax Policy. Certain criteria were established to determine which tax provisions should or should not be included in that list. As required by the 1974 Congressional Budget and Impoundment Act, an updated list of tax expenditures and their "cost" to the government has been published every year in the Federal Budget.

Several items of great interest to higher education are included in the tax expenditure list. Those we wish to comment on are: the deductibility of charitable contributions; exclusion of interest on tax-exempt student loan bonds; employer educational assistance; and the research and development tax credit.

Voluntary giving, which provides vital financial support for American colleges and universities and other charitable institutions, is encouraged by federal tax laws that were enacted in recognition of the value of nonprofit charitable institutions to society. The charitable deduction was incorporated into the Income Tax Law of 1913 as a stimulus to encourage the giving of wealth for public purposes. Thus, Congress has for over 65 years recognized the important services provided by charitable organizations in meeting public needs. Private philanthropy has always been viewed as a cornerstone of our pluralistic society.

Although the tax expenditure list may serve a useful purpose, it is inappropriate that the charitable deduction be included. While most items on the tax expenditure list yield a personal financial benefit to the taxpayer, the charitable deduction encourages donations of personal property which inure to the public good. Every dollar contributed to charitable organizations goes to a public purpose activity.

The tax policy reasons for excluding the charitable deduction from the list are compelling. Money voluntarily given to worthy public causes should not be counted as "income" in an income tax system that taxes a person in accord with his ability to pay. A person's annual ability to pay tax is properly measured by his annual personal consumption and annual net accumulation of wealth. In the case of amounts donated to education and other charitable activities, the benefits produced have the character of public goods where consumption by one person does not preclude consumption by others. No one individual should be taxed as if he had consumed the goods himself. The charitable deduction guarantees that individuals will not be taxed on amounts they devote to public use through philanthropic giving. Since the money donated to charitable organizations is not available to the taxpayer to be consumed or saved, the charitable deduction should be seen as a procedure to define the amount of income subject to tax.

Another compelling tax policy argument against inclusion of the charitable deduction in the tax expenditure list is that typically, the list assumes that the government is choosing between a direct grant and inclusion as a tax expenditure. In certain cases involving charitable organizations, however, the government is prohibited from giving direct grants and therefore, there is no choice. Direct grants to many charities, such as sectarian religious organizations, are prohibited by several state constitutions.

If one accepts, for the sake of argument, the validity of the tax expenditure theory, and the correctness of placing the charitable deduction on the tax expenditure list, the deduction clearly merits retention in the tax code . The charitable deduction, for both itemizers and nonitemizers, is effective, efficient and equitable.

It is effective as evidenced by annual increases in charitable giving. The deduction for nonitemizers, when fully effective in 1986, is expected to generate $5.7 billion annually for public purposes. This would mean an average increase in giving of approximately 12 percent.

It is efficient. Data compiled by Martin Feldstein, currently chairman of the Council of Economic Advisers, show that every dollar of revenue foregone for the government through the charitable deduction yields approximately $1.19 in voluntary support for charitable institutions. In fact, while the deduction for nonitemizers is expected to generate $5.7 billion for charities, the Treasury would take in only $4.8 billion less.

It is equitable. The charitable deduction increases the progressivity of the tax system because people in higher tax brackets tend to give a larger portion of their earnings than the people in the lower income tax brackets. Thus, the equity of distribution of income in our society is increased by the availability of the charitable deduction. The deduction for nonitemizers is especially equitable for low and middle income taxpayers who do not itemize their deductions. It would give recognition to every taxpayer making charitable gifts for public purposes.

The effectiveness, efficiency and equity of the charitable deduction for both itemizers and nonitemizers clearly show the validity of the deduction as a tax expenditure.

As for the exclusion of interest on tax-exempt bonds, we ask that current law be maintained. Last year, in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress recognized the public purposes that colleges and universities serve, requiring only reporting and registration in the case of student loan bonds or bonds for tax-exempt organizations. We supported those provisions and suggest that no new conditions exist that would indicate a need for further changes in the law. We ask Congress to reassert that recognition and continue the treatment of colleges and universities as stated in TEFRA. We also ask that such public purpose bonds not be included in any type of state volume cap.

The nontaxable status of employer educational assistance expires Dec. 31, 1983. We support a permanent extension of that provision of the tax code and also support inclusion of educational benefits for both spouses and dependents.

Finally, the research and development tax credit, passed as part of the Economic Recovery Tax Act of 1981 (ERTA), should be made permanent and a discussion should be initiated to consider allowing a non-incremental credit for industrial expenditures on university-based basic research. Basic research, defined by ERTA, as "any original investigation for the advancement of scientific knowledge not having a specific commercial objective..." is ultimately the essential source of industrial innovation and provides the intellectual basis for our international competitiveness. One of the more effective ways to transfer knowledge, developed in the university laboratory, to the market place is to encourage university-industry cooperative research projects. An appropriately modified research and development tax credit will provide for increased university-industry cooperation and will improve the vitality of the U.S. economy.

## STATEMENT OF
## THE RETAIL TAX COMMITTEE OF COMMON INTEREST
## SUBMITTED TO
## THE COMMITTEE ON FINANCE
## UNITED STATES SENATE

"The 15-Year Accelerated Cost Recovery for Buildings"

June 28-29, 1983

### Introduction

The Retail Tax Committee of Common Interest represents nine major retailing companies,*/ the American Retail Federation, and the National Retail Merchants Association on federal tax matters that are of interest to the retailing sector of the economy. Retail sales represent approximately 33 percent of the GNP and provides jobs for 12 million employees.

This statement presents the retail sector's views with respect to the 15-year accelerated cost recovery system (ACRS) category for buildings. The benefits of ACRS in excess of straightline deductions is not listed as a so-called

---

*/ Allied Stores Corporation; Associated Dry Goods Corporation; Carter Hawley Hale Stores; The Dayton Hudson Corporation; Federated Department Stores, Inc.; R. H. Macy & Company, Inc.; The May Department Stores, Inc.; J. C. Penney Company, Inc.; Sears, Roebuck and Company.

"tax expenditure" in Special Analysis G of the Administration's budget documents for FY 1984. However, depreciation on buildings in excess of straightline is explicitly listed in both "Estimates of Federal Tax Expenditures for Fiscal Years 1983-1988," page 13, published on March 7, 1983 by the Staff of Joint Committee on Taxation, and in "Tax Expenditures: Budget Control Options and Five-Year Budget Projections for Fiscal Years 1983-1987," Table A-1, published in November 1982 by the Congressional Budget Office. While not approving of the concept and terminology of "tax expenditures," the retail sector does want to discuss the 15-year ACRS category for buildings which is found on such lists.

## Summary of the Issue and Recommendation

ACRS permits the cost of buildings to be recovered over 15 years using rapid deduction methods. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the ACRS improvements for cost recovery for machinery and equipment, based on a belief that ACRS was "too generous". This terminology is now being used in support of alternative proposals to severely curtail the ACRS improvement in cost recovery for buildings.

## The Issue and Background

ACRS for Buildings. ACRS created a 15-year write-off category for all new or newly acquired buildings. The deductions for such property are determined using tables supplied by Treasury based on the 175 percent declining balance method with a subsequent swith to straightline when the latter becomes more favorable. The first year's deduction is based on the number of months during which the property is in service. At the taxpayer's option, a slower recovery can be elected based on straightline deductions over a 15-, 35- or 45-year period.

Cost Recovery and Investment. Increased efficiency and productivity in the distribution of goods and services requires a continuing capital investment program in new technologies and more energy efficient assets, just as is the case for heavy manufacturers, for transportation companies and for other business sectors. The years of high inflation and costly financing in the mid-to-late 1970s made replacement of antiquated or inefficient assets and modernization of facilities very difficult. As a result, business' ability to make the new capital investments so necessary for economic growth has been slowed.

By increasing the pace at which such capital investment outlays are recovered, ACRS--

(1) reduces the disincentive inherent in the federal income tax with respect to business' capital improvements,

(2) offsets part of the impact of inflation and high interest rates, and

(3) recognizes the relationship between rapid recovery of capital investment and economic growth.

Without the benefits of ACRS that have been available since 1981, new investment by many sectors probably would have been even lower than actually recorded levels, thus adversely impacting an already weak economy.

Whereas machinery and equipment are the servants of manufacturers, buildings are the tools of retailers who are the essential link in the chain between the manufacturer and the consumer. Efficient, modern, technologically up-to-date buildings are critical in carrying out the retailer's distribution tasks. These buildings are the single largest fixed capital outlay normally made by retailers. Accordingly, particularly in inflationary periods, the more rapidly capital expenditures for structures can be recovered, the faster these dollars can be reinvested in new, modern, more productive facilities and distribution processes.

Federal Tax Law. However, federal tax law historically imposed lengthy depreciation periods on buildings. Depreciation periods of 25 to 40 years were common, thereby stretching the recovery of capital invested in a building over an excessively long expanse of time. Furthermore, buildings were denied the most accelerated deduction techniques that were available for machinery and equipment.

As enacted in 1981, ACRS for buildings--both the 175 percent declining balance method and the shorter 15-year recovery period--provides a stimulus much like the investment credit available for machinery and equipment. Since buildings do not qualify for the investment credit, the potential profit from an investment in a building can be increased only by a reduction of current costs. If the cost recovery period were lengthened, or the deductions were less accelerated, the overall costs of constructing stores, warehouses or manufacturing facilities would increase as a result of a change in the cash flow generated by depreciation deductions. In other words, the net present value of the investment's tax benefits would be reduced.

Inflation. A short recovery period and a reasonably accelerated deduction mechanism also help offset the adverse effects of inflation in measuring dollar value. When expenditures are made in one period, and after a period of inflation, are recovered in the future through depreciation deductions, the real capital returned to the business will be materially less valuable than the original capital invested. Similarly, a slow rate of deductions which delays the cost recovery also results in a loss of capital to the investing business. Thus, the longer the capital cost recovery period, or the slower the rate of deductions, the greater the risk associated with the capital expenditure. The effect of inflation on capital expenditures is so material that regulatory and professional groups (e.g., the SEC and AICPA) are continually studying, proposing, and promulgating rules requiring business to disclose inflation-adjusted financing information to the public.

Investment. A short and accelerated cost recovery period, coupled with reduced financing costs, aids business in obtaining realistic returns on investment in capital expenditures. Again, the faster capital investments are recovered, the faster these dollars can be reinvested. This effect is particularly notable in retailing where buildings comprise a disporportionately large portion of a taxpayer's fixed assets. Retailing dollars reinvested in buildings permit construction not only of modern, efficient structures, but also provide related benefits such as--

- employment opportunities for full-time career seekers and part-time workers such as mothers, students and elderly alike, and
- due to the competitive nature of retailing, cost savings resulting from investment in efficient distribution facilities that can be passed on to the consumer.

### Current Proposals To Limit ACRS

Among the list of revenue raising tax proposals in 1982 and again this year is a substantial retrenchment in the ACRS improvements for buildings. Three proposals listed in 1982 were the following:

(1) a 20-year/175% db method;

(2) a 15-year/125% db method; and

(3) an 18-year/straight-line method.

The CBO estimates that item (1) would raise taxes on corporations by $15.8 billion and on individuals by $3.6 billion from FY 1984 through FY 1988.

### Undefined Opposition to ACRS for Buildings

The general argument presented in support of restrictions on the ACRS treatment of buildings is that it is "too generous," but what is meant by that phrase is unclear.

"Better Than Expensing." In TEFRA, ACRS was deemed to be "too generous" for machinery and equipment because, in combination with the ITC and lower interest or inflation rates, it produced a result that was deemed to be better than a 100 percent write-off, or expensing, in the first year. In other words, the combined net present values of ACRS and the ITC were better than the net present value of expensing. But for buildings, the still-lengthy 15-year recovery period with no ITC is far from being the equivalent of expensing. Only qualified rehabilitation expenses for old buildings are eligible for an ITC. Even then, the taxpayer must use a straightline method for deductions and must make a full basis adjustment (a 50 percent adjustment for historic structures). Thus, even the cost recovery treatment of rehabilitated buildings does not approach the equivalent of expensing.

A Different Kind of Asset. If "too generous" means that a building is viewed to be a different kind of capital asset and, therefore, should be treated more onerously than machinery and equipment, the observation is not well founded. The building which houses a retail store is just as critical to the retailer as the machine tool is to an automobile manufacturer and as the jet aircraft is to the airline. The particular mix of various kinds of assets that any firm or sector acquires is dictated by the requirements of its business and the efficiency and productivity of such assets. The distinction between real property and personal property may have an extensive history in federal income tax law, but the company which conducts an active trade or business cannot view its building as an asset totally divorced from the machinery or fixtures contained therein. Adverse tax consequences with respect to the former imposes an unjustifiable economic burden on the business decision to invest in needed structures.

Policymakers should be aware that buildings in fact are treated more severely than equipment under ACRS, even after the curtailment of ACRS for equipment by TEFRA. Since the enactment of the ITC and administrative reductions in write-off periods in 1962, effective tax rates on income from investments in machinery and equipment have fallen dramatically in comparison to rates on income from investments in buildings. In 1981, ACRS significantly reduced the tax burden on investments in buildings, but the historical differential was actually maintained by the simultaneous ACRS/ITC improvements for machinery and equipment. Furthermore, the differential would have increased when the two final steps of ACRS for machinery and equipment became effective in 1985 and 1986. By repealing the final steps and by imposing a basis adjustment for one-half of the ITC, TEFRA generally eliminated the increased differential. But investments in buildings remain subject to a higher tax burden than post-TEFRA investments in equipment, just as was the case before ACRS was enacted.

Tax Shelter Concerns. Finally, "too generous" may indicate lingering or renewed concerns about the use of buildings in tax shelter circumstances. This certainly is not an issue with respect to active businesses such as retailers. If there are churning or recapture problems or other issues with respect to individual investors who use ACRS on buildings for tax planning and avoidance purposes, these matters should be addressed directly. A sweeping change in ACRS itself for all buildings would penalize those who are making the intended use of the system with respect to their buildings.

Recommendation

The current 15-year/175% db provisions for buildings should be left untouched. Any concerns related to questionable tax practices with respect to buildings should be directly addressed rather than allowed to penalize the productive businesses that place very heavy investments in buildings.

# STATEMENT OF
# SOUTHEASTERN LUMBER MANUFACTURERS ASSOCIATION

before the

SUBCOMMITTEE ON ESTATE AND GIFT TAXATION
COMMITTEE ON FINANCE
U. S. SENATE

JUNE 28, 1983

The Southeastern Lumber Manufacturers Association (SLMA) representing 435 lumber manufacturers in the 12 southern states is pleased to submit this testimony on estate tax law to the Committee.

SLMA supported the inclusion of estate tax reform in the National Economic Recovery Act, the 1981 tax act. We oppose the proposal to freeze estate tax exemption at this year's level of $275,000 and the estate tax rate at 60 percent.

We urge the Committee to oppose the idea and to allow the scheduled phase-in of the changes made in the unified gift and estate tax credit and rate cuts to run their course.

The reasons estate tax reform were enacted in 1981 are the same reasons the scheduled phase-in of the changes in the credit and the rate should be fully implemented. Enactment of the 1981 estate tax provisions was a recognition by the Congress that inflation had devastated the estates of small business owners, such as SLMA's members, and family farmers. An increase in the credit was necessary just to protect estates from the ravages of inflation during the 1970's.

Congress recognized that heavy estate taxes, combined with spiraling inflation, had made it exceedingly difficult for small business owners to pass their businesses on to their children. That situation has not changed as the nominal value of estates has still been artificially increased by inflation. Today's reduced rate of inflation has done nothing to reverse the adverse consequences of inflation on estates during the 1970's. As a result, we firmly believe the 1981 estate tax provisions should go into effect.

SLMA does not believe Congress should reimpose the estate tax barriers to passing on family owned businesses which it removed only two years ago. Congress' action was right then and it remains right today.

# # # #

The Tax Council

OFFICERS
ROBERT C. BROWN
*President*
DOUGLAS P. BATES
*Executive Director*

June 27, 1983

The Honorable Robert J. Dole
Chairman
Senate Committee on Finance
Washington, D.C. 20510

Dear Mr. Chairman:

This letter and the accompanying analysis serve as the Tax Council's submission to the Senate Finance Committee's call for hearings on the general topic of "tax expenditures." The Tax Council is a business organization comprised of a broad spectrum of corporate enterprise for the purpose of advancing stable, capital conscious federal tax policy.

It is the view of the Tax Council that:

(1) The definition of tax expenditure is critical both to the concept and level of the listed items. There is no such thing as a "normal" income tax, except in the eyes of the beholder.

(2) A number of items currently listed in the tax expenditure budget serve the primary purpose of measuring real income or counteracting an existing tax penalty. These items would appear to be part of a "normal" income tax structure, at least in the view of the legislature which enacts and maintains them. As detailed in the attached analysis, nine major tax provisions affecting individuals now classified as tax expenditures can be reasonably shifted out, reducing the total tax expenditure budget by 45%. Similarly, at least seven major tax provisions affecting the corporate sector can be removed from the list, reducing the corporate sector tax expenditure list by 57%.

(3) The distribution pattern of the current tax expenditures list shows that upper income groups do employ a higher proportion of the dollar volume of tax expenditure items. Of course, these same groups also pay proportionately more in tax liabilities. Measuring the relative benefit of tax expenditures to taxes paid reveals that the lowest income group (0-$10,000 AGI) receives $1.38 of tax expenditure for every $1 tax paid. All other income groups fall randomly within the range of $.40 per tax dollar for the $200,000-and-above income group to $.59 per tax dollar for the $50,000-100,000 income group.

(4) If the items under question in our analysis are deleted from the tax expenditure list, the distribution shifts significantly toward the lower end of the income scale. Further, if the zero bracket amount were considered a tax expenditure, the ratio of tax expenditure to tax liability becomes strongly progressive, moving from $1.69 per $1 paid by the 0-$10,000 income class to $.16 per $1 tax paid by the $200,000-and-above group.

The principle that underlies the attached analysis and, in general, represents the Tax Council's view of better tax policy is that capital formation and preservation are necessary conditions to achieving real economic growth, increased productivity and employment, and continued improvement in the quality of all human life. This role of capital has been recognized and encouraged through many of our tax laws since the inception of the income tax in 1913. It has also been neglected in the drafting of many other tax provisions. We, therefore, challenge the label, "tax expenditure," with all its negative connotations, when it is attached to provisions that attempt better measurement of real income or offset existing tax penalties.

Finally, we are concerned that these hearings may be misconstrued as the vehicle for consideration of revenue raising options now that the First Concurrent Budget Resolution for Fiscal 1984 contains reconciliation instructions calling for $73 billion of additional tax revenues over the period Fiscal 1984-86. Should such a legislative effort be undertaken, the Tax Council would be pleased to address the specific tax issues and legislative proposals that your committee wishes to review in the context of mandated tax increases.

Sincerely,

Wilfred J. Tremblay
Chairman

WJT/ses

enc

# STATEMENT OF THE TAX COUNCIL
# ON THE TAX EXPENDITURE BUDGET
# TO THE COMMITTEE ON FINANCE,
# UNITED STATES SENATE

June 28, 1983

## AN ALTERNATIVE TAX EXPENDITURE BUDGET

### Background

The debate over "tax expenditures" has now become a perennial. It is, in part, a vestige of the tax reform movement that petered out in the late 1970s. What could not be accomplished in the way of closing "loopholes" directly through the regular tax legislative process just might be achieved with help from instructions from the budget committees.

Theoretically, a wholesale cutback in special income tax provisions could result in significantly lower basic tax rates. And certainly the income tax code has become much more complex because of the existence of multiple tax relief provisions for both individuals and the corporate sector. The possibility of using the tax expenditure budget as leverage for a simpler system is its basic public appeal.

While most advocates of the tax expenditure budget lament the alleged uncontrolled growth of such expenditures and the asserted lack of Congressional oversight, there is also a hidden agenda. The claim is often made that tax expenditures disproportionately benefit upper income groups and the corporate sector. Somehow, in this view, the government--and by extension most of the population--is being cheated out of its rightful share of national income because of these tax expenditures. The power to control or even to influence such tax provisions, of course, is the power to redistribute income. The truest believers in the tax expenditure budget are apt to favor a highly progressive individual income tax and look upon the federal government as an active agent of income redistribution.

A practical objection to tax expenditures is the difficulty in measuring them. Unlike budget accounts, tax expenditures cannot easily be aggregated for the purpose of meaningful review and evaluation of their overall economic impact. In fact, the Special Analysis G of the Budget consistently has contained a specific warning against aggregating the individual items and does not present a total of them because changes in various tax provisions can induce changes in taxpayer behavior affecting the value of other tax provisions. This is particularly pertinent with respect to special provisions affecting savings and investment.

Another principal problem with both the substance and measurement of tax expenditures--and the focus of the following analysis--is their essentially arbitrary definition. Supposedly, everything outside of the "normal" structure of the income tax is a tax expenditure. According to the 1974 Congressional Budget Reform Act, which first mandated the tabulation of tax expenditures on a regular basis, they are "revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax or deferral of tax liability." The Joint Taxation Committee goes on to define "tax expenditures" as any departure from a comprehensive tax base and any departure from the definition of net income other than the business costs of earning that income.

It is the position of this paper that:

(a) There is no such thing as a "normal" income tax except in the eyes of the beholder. That while it's obvious that special tax provisions have proliferated in recent years and that they have made the income tax structure more complex, these facts by themselves do not justify using arbitrary standards of classification for purposes of deciding what is abnormal in the tax structure and hence the subject of special conditions as to continuance, modification, or elimination.

(b) Making relatively small changes in the definition of "normal" tax structure can result in massive changes in the level and distribution of tax expenditures. This will be developed in the section on an alternative tax expenditure budget.

Supporters of the tax expenditure budget concept tend to dismiss the definitional problem as a matter of semantics. But far more is involved. Without a firm foundation as to what constitutes a tax expenditure, the whole case for subjecting some provisions of the law to more rigorous tests than others tends to crumble.

Up until now, there has been no serious challenge as to what is and what is not included in the tax expenditure budget. The decisions are made arbitrarily by the bureaucracy. Perhaps not too much attention has been paid to this because up until now nothing has been done about tax expenditures specifically other than to list them. Sunset legislation and/or subjecting tax expenditures to a statutory budget limitation could change this situation drastically. But even without sunset, the regular tabulation of tax expenditures, going on for the past ten years, is cloaking the concept with an authority of its own. And from that authority comes the power to influence, if not control, the direction of future tax policy.

## The Current "Budget"

From the start, the official list of tax expenditures as it appears in the Budget's Special Analysis G and elsewhere has been fairly inclusive. If the tabulators had any doubts to some provisions, they resolved them, in general, by throwing the provisions into the tax expenditure pot.

The total number of listed tax expenditures now stands at 109, with an estimated "revenue cost"(1) in Fiscal 1984 ranging from $10 million tax credit for orphan drug research to over $50 billion for the net exclusion of pension contributions and earnings. The aggregate total of the separate tax expenditure items is projected at $327 billion in Fiscal 1984, about one-third the size of direct Federal Government expenditures under the unified budget. Of this total for Fiscal 1984, $260 billion or 80% would be for individuals and the balance, $68 billion, for the corporate sector.

Existing tax expenditures in general are projected by the government to grow fairly rapidly over the next five years. According to the projections of the Treasury and the Joint Committee on Taxation, the totals will increase at about 11% per year to $491 billion between Fiscal 1983 and Fiscal 1988. This would result from increases in income, whether real or inflationary, that allow more income to receive special tax treatment and because of the cumulative effect of legislative changes in recent years which, on balance, liberalized the tax provisions making up the tax expenditure budget.

As indicated, the tax expenditure budget is a full one. Nevertheless, there are some curious omissions. The two most obvious, and of very significant revenue consequence, are the personal exemption and the zero bracket amount. Both are considered part of the "normal" tax structure. Yet the the split rates on corporate income under $100,000 are considered tax expenditures. Even though the purpose--to shield the smaller corporation from the full tax burden--is very much the same as the personal exemption and the zero bracket amount for lower income individuals. The basic rationale for the zero bracket amount (formerly standard deduction) is to give middle and low income individuals a similar tax deduction as taken by those who itemize deductions separately. Yet all itemized tax deductions are considered tax expenditures and the zero bracket amount is not.

---

(1) Defined as the first-order estimate of the revenue gain that would result from the elimination of a particular provision on a "one-at-a-time" basis.

As will be developed further, this type of classification carries very significant implications for the distribution of tax expenditures by income class.

## Distribution of Tax Expenditures

In 1975, a report requested by then Senator Walter Mondale made estimates of the distribution of tax expenditures by income class. These estimates have been updated for some items according to present law at 1981 income levels. However, the last comprehensive distribution for all listed tax expenditures for individuals applies to Fiscal 1981 in a report prepared by the Department of Treasury. It is unlikely that the distribution pattern of the published tax expenditure list has changed significantly since then.

The summary of that 1981 distribution is presented below.

TABLE 1

Distribution of Tax Expenditures and Tax Liability, Ratio of Tax Expenditures to Tax Liability by Income Class ($bils., Fiscal 1981)

| Income Class(AGI) | Number of Returns (mils) | Tax Expenditures |  | Tax Liability |  | Ratio: Expenditure to Liability |
|---|---|---|---|---|---|---|
|  |  | Total | Distribution | Total | Distribution |  |
| 0-10 | 36.3 | $ 12.1 | 7.7% | $ 8.8 | 3.0% | 1.38 |
| 10-15 | 14.2 | 8.6 | 5.5 | 17.7 | 6.1 | .49 |
| 15-20 | 11.0 | 9.7 | 6.2 | 23.4 | 8.0 | .42 |
| 20-30 | 16.3 | 27.2 | 17.4 | 57.1 | 19.6 | .48 |
| 30-50 | 13.4 | 46.7 | 29.8 | 88.2 | 30.2 | .53 |
| 50-100 | 3.4 | 31.1 | 19.8 | 52.6 | 18.0 | .59 |
| 100-200 | .5 | 12.2 | 7.8 | 22.1 | 7.6 | .55 |
| 200+ | .14 | 9.1 | 5.8 | 22.8 | 7.8 | .40 |
| Summary Table |  |  |  |  |  |  |
| 0-20 | 61.5 | $ 30.4 | 19.4% | $ 49.9 | 17.1% | .61 |
| 20-50 | 29.7 | 73.9 | 47.2 | 145.3 | 49.8 | .51 |
| 50+ | 4.04 | 52.4 | 33.4 | 97.5 | 33.4 | .54 |

Source: Office of Tax Analysis, U.S. Department of Treasury and Tax Council computations.

The table indicates that a large share of the tax expenditures affecting individuals went to a small proportion of taxpayers at the upper income levels. Specifically, 33.4% of the dollar value of all tax expenditures benefitted 4.3% of the taxpayers -- those with incomes over $50,000. When the proportion of actual taxes paid by the various income groups is matched up with their share of tax expenditures, the distribution looks more even. That relatively small group of taxpayers with incomes over $50,000 paid 33.4% of the total individual income tax. The broad middle and upper-middle income groups ($20-$50,000) received 47.2% of tax expenditure benefits and paid 49.7% of the tax. Low and middle income groups (below $20,000) received a higher proportion of tax expenditures (19.4%) than they paid in tax liabilities (17%).

Taking the ratio of listed tax expenditures to tax liabilities, we find that the relative "benefit" of tax expenditures is lowest at the $15,000-$20,000 income level and the $200,000+ income level. The highest relative "benefit" accrues to the 0-$10,000 income level.

This is really not surprising since the purpose of a great number of listed tax expenditures is to provide more income security at the low end to counteract the effect of high marginal rates of tax at the high end.

## Measuring Real Income

The conceptual base of the existing tax expenditure budget relies heavily on the Haig-Simons definition of income, i.e., the sum of consumption and changes in net worth during the period in question. Acceptance of this concept leads one to describe as "normal" a fairly comprehensive tax base that would subject many forms of income, not now liable, to income taxation. However, the existing tax expenditure budget is more selective than any rigorous application of the Haig-Simons definition would permit. For instance, under the latter, the imputed value of owner-occupied housing and housewives' services surely would be subject to tax. But they are not, nor are they included in the tax expenditure budget. This is not surprising considering that the estimated dollar value of imputed homeowners' rent alone runs well over $200 billion per year and would completely swamp the existing tax expenditure budget both statistically and politically.

Real income, particularly in the inflationary environment of the past fifteen years, would appear to be considerably less than the Haig-Simons definition. For purposes of this paper, we make no attempt to substitute any elegant definition that would stand the test of thorough analysis in every case. We will look at some of the major tax expenditures listed in both the individual and corporate sectors to see if they fit a deliberately more relaxed view of what constitutes real income. If the particular tax provisions appear to serve more to measure income for tax purposes or to counteract the effect of related tax penalty provisions than to serve nontax goals, they will be excluded from our "alternative" tax expenditure budget. We make no pretense that this will result in a purer list of tax expenditure. In fact, we doubt that such can be produced with any wide-scale consensus. We deliberately will exclude major items when there appears to be significant doubt as to their "abnormality" in a reasonable measurement of income. And, again, to make the compilation manageable, we will examine only some of the major items leaving a considerable number on the tax expenditure list which a more detailed review using the same basic assumptions might well exclude.

## Individual Sector

### Capital Gains

There are three major tax expenditure items in the capital gains area affecting individuals:

| | | Estimated FY'84 Revenue Cost ($ mils.) |
|---|---|---|
| (1) | The general 60% capital gains exclusion (other than for farming, timber, coal and iron ore). | $ 14,320 |
| (2) | Step-up of basis on capital gains at death. | 3,565 |
| (3) | Deferral of capital gains on home sales and exclusion of gains on sales for those age 55 and over. | 6,525 |
| | | $24,410 |

The history of capital gains taxation in the U.S. is convoluted. It started with inclusion of capital gains in income to be taxed at ordinary rates in the 1913-1921 period. In the 1930s there was experimentation with the sliding scale approach whereby gains were subject to lower tax rates the longer the assets were held. There was a fairly long period of stability in the 1942-1969 era when capital gains were taxed at half the regular rates with a 25% maximum. Since 1969, there has been both a general stiffening of tax treatment, particularly through the minimum tax, and then an easing in the 1978 legislation which raised the basic exclusion to 60% and effectively removed capital gains from the minimum tax.

For those inclined to the Haig-Simons income concept, which includes changes in net worth, the capital gains exclusion is an obvious tax expenditure. So is the step-up in basis of capital assets acquired at death, which allows intergenerational and other transfers to "escape" income taxes.(2)

Chinks in this argument have become more noticeable as inflation has worsened over the past fifteen years. To the extent that nominal capital gains represent simple inflation in asset values, no additional real capital is created and taxation of those gains erodes our capital base. Citing of this inflation factor was instrumental in obtaining some tax relief for capital gains in the 1978 act and has led to proposals to index the basis of productive assets so that the inflation component would not be subject to tax.

A much more basic argument is made that capital gains are not income -- period -- that only the stream of production giving rise to income should be taxed, not the capital employed. Most savings of individuals have already been subject to income tax, of course, as they were earned in the stream of production. This argument emphasizes the public interest in enhancing the nation's stock of capital for a more productive economy for all. The double taxation of capital, in this view, once as it is created (saved) in the production process, and then through the capital gains tax on transfers, significantly diminishes our capacity to produce -- to the detriment of all.

The argument also is made that the preservation of capital can be just as important as new capital formation particularly in practical terms in maintaining a healthy small business community -- in preserving continuity of management and survival of enterprise. Accordingly, the step-up of basis for capital assets at death would be considered a means of mitigating the adverse effect of estate taxation on capital preservation. The thrust of this argument was very evident in persuading Congress to reverse its position on the

---

(2)In fact, a literal acceptance of Haig-Simons would mandate taxing both realized and unrealized capital gains. Proponents of the latter just haven't figured out how on a practical basis.

carry-over basis matter. The carry-over basis provision of the 1976 Tax Reform Act was a partial proxy for taxing gains at death, but a coalition of investors, small businesses and farmers beat it down within three years, a remarkable turnabout on such a major reform issue.

The case for not taxing capital gains as income has never prevailed fully in the U.S. (although it has elsewhere). But it has been strong enough to force special treatment of capital gains going back almost to the beginning of the income tax system when inflation was not really a problem. Thus, a basic argument certainly can be made that it is taxation of capital gains, giving in to populist sentiment, that is the abnormality. The partial exclusion, the deferral of taxes on home sales and the step-up of basis at death are all ameliorations of the tax penalty imposed by income taxation of capital regardless of the inflation rate. In this view, they should be removed from the tax expenditure list -- not just to the extent of the effect of inflation on capital, but entirely.

## State and Local Taxes

Second only to pension contributions by employees in the tax expenditures list for individuals is the deductibility of state-local taxes, specifically property taxes on homeowners and other nonbusiness state and local taxes, mainly income and general sales taxes.

| | | Estimated FY'84 Revenue Cost ($ mils.) |
|---|---|---|
| (4) | Deductibility of property taxes on owner-occupied homes. | $ 9,535 |
| (5) | Deductibility of other nonbusiness state and local taxes. | 21,770 |
| | | $31,305 |

State and local taxes have been deductible from the federal income tax system all along, even going back to the Civil War tax. Although the deduction for state-local taxes for tobacco and alcohol was eliminated in 1964 and for gasoline in 1978, the Congressional view of the general state-local tax system is clearly that it reduces real income and should be deductible from the individual income tax base. The 1978 Administration proposal to do away with the general sales tax deduction on grounds of simplification garnered no support whatsoever in Congress.

Followers of Haig-Simons may claim that state-local taxes are really payments for consumer "services" -- schooling, fire and police protection, local roads, etc. -- of benefit to the taxpayers and therefore should not be considered outside of a comprehensive tax base. But if so, these are "services" over which individual taxpayers have very little choice. Unless you happen to live at a marina in a state with no income tax, a food/drugs exemption from sales tax, and acquire your other goods from an out-ofstate mail-order house, you are going to pay state-local taxes whether or not you enjoy their "services."

The deductibility of home property taxes has been called a subsidy to home ownership and discriminatory to renters. However, landlords do take property tax payments as a business cost deduction and in a competitive real estate market are forced to pass these savings on to renters. Ironically, under the real Haig-Simons income concept, which includes the imputed value of homeowners rent, home property tax liability would have to be considered a business cost and not a tax expenditure.

Over the postwar period, property and state-local income and sales taxes have risen sharply, faster than federal taxes, and have become a very signficant burden on the economy and on peoples' real income. This area of deductibility appears to be one of the weakest links in the tax expenditure budget.

Pensions

| | Estimated FY'84 Revenue Cost ($ mils.) |
|---|---|
| (6) Net exclusion of employer share of pension contributions and earnings. | $ 56,560 |

No question that there is a tax benefit involved in the treatment of qualified pension plans. It is claimed that the tax expenditure element in these plans stems from: (1) the fact that employer contributions are not taxed until distributed as pension benefits when the retired employee is likely to have a lower marginal tax rate; and, (2) that the total of employer pension contributions and investment earnings are greater than the amounts paid out as taxable benefits. This, it is claimed, gives the employee with a vested pension the equivalent of an interest-free loan.

In the view of the individual taxpayer, if the employer contribution were made taxable currently, where is the matching real income to pay the tax? The "deferral" system as applied to employer pension contributions was set by Congress back in 1921 and continued since then to encourage more employers to establish retirement programs for their employees. The treatment recognizes the basic principle of not taxing compensation or other income until it is actually received, which accords with a Congressional view, at least, of equity and administrative practicality. The alternative of current taxation of the employer contribution would impose a tax penalty on the establishment of private retirement plans. In the strictest sense, the tax expenditure element involved here is the present value of the marginal rate differential between the time the contribution is made and the time received and the present value of the difference between the contributions and earnings accumulated and taxable benefits received. The probability that the beneficiary will have a lower tax rate at receipt of the income and will enjoy part of the fruits of investment earnings is certainly helpful to the beneficiary. But is it therefore abnormal tax treatment?

If private pension contributions should not be classified as tax expenditures, what about the employer contributed share of social security benefits? The legislative history here is murkier. Prior to 1983, Congress never explicitly acted on the social security exemption. The exempt treatment derives from court decisions and IRS rulings that there is no contractual right to such benefits and that they are in the nature of government "gratuities" not subject to tax. In legislation enacted this year, however, Social Security benefits of certain individuals are subject to tax for the first time in the history of the program--a major step toward aligning the tax treatment between Social Security benefits and private pension plans.

A grayer area would be the treatment of retirement programs for the self-employed such as IRA and Keogh plans, and the exclusion of employer provided premiums on group term life insurance and medical insurance. Here there more clearly is a current income benefit which there may be good reasons for not taxing but which are harder to classify as part of a "normal" tax structure.

| Medical Expenses and Casualty Losses | Estimated FY'84 Revenue Cost ($ mils.) |
|---|---|
| (7) Deductibility of medical expenses. | $ 2,630 |
| (8) Deductibility of casualty losses. | 380 |
| | $ 3,010 |

Medical expenses in excess of a certain percentage of Adjusted Gross Income have been deductible since 1942. Congress was concerned about the effect of very high wartime income tax rates on those with significant medical bills. The initial general medical deduction was limited to a $2,500 maximum and allowed only in excess of 5% of AGI. The AGI percentage floor was tightened in the 1982 tax legislation. The dollar maximum limit was eliminated in 1965.

As with a number of other itemized deductions, it has been charged that the tax benefit of the medical deduction goes well beyond those suffering catastrophic or even unusually large medical expenses. A significant number of taxpayers with less than average medical expenses (said to be about 8% of income currently) are able to utilize the itemized deduction. Nevertheless, there is a significant sentiment in Congress that such expenses, whether only a little over 5% of income or much higher, are still a subtraction from real income. And particularly without the provision of government-supported medical care for the bulk of taxpayers, there should be a recognition in the tax law for the hardship of medical expenses. According to this view, the specific percentage allowed is a matter of legislative prerogative and should not be controlling as to whether the deduction is a normal or abnormal part of the tax system.

The analysis of nonbusiness related casualty losses is almost an exact parallel with medical expenses, and the treatment has been modified in 1982 to a pattern much like medical expenses. Total casualty losses are now deductible in excess of 10% of AGI and $100 per occurrence. Besides denying the deduction for many taxpayers, this effectively increases their cost for casualty insurance.

## Interest and Dividend Exclusion

| | Estimated FY'84 Revenue Cost ($ mils.) |
|---|---|
| (9) Interest and dividend exclusion | $ 435 |

This exclusion often has been characterized as an obvious tax expenditure for individuals. It clearly benefits middle and upper income taxpayers because of their higher marginal rates and because they are more likely to be corporate shareholders.

But, once again, we find extenuating circumstances. It goes back to the 1954 Code when a $50/$100 exclusion and a 4% dividends received credit above that amount were enacted as a small offset to the double taxation of corporate earnings. The credit was repealed in 1964 but the exclusion was doubled to $100/$200. Under the windfall profits tax of 1980, the exclusion was doubled again to $200/$400 for both dividends and interest combined, effective in 1981.

Economists have claimed that a small dividend exclusion is not a particularly effective means of encouraging additional savings or counteracting the double taxation of corporate earnings -- once at the corporate level and then again at the shareholder level. But just because it may not have been all that potent does not make it abnormal. In fact, the exclusion is a partial relief for a much bigger tax penalty on capital -- a reverse loophole, if you will.

It is questionable to list the exclusion as a tax expenditure just because Congress has not seen fit, whether for revenue cost reasons or otherwise, to eliminate the double taxation penalty itself.

### "Net" Level and Alternative Distribution of Individual Tax Expenditure Items

The above possible deletions from the FY 1981 tax expenditure budget are summarized as follows:

| | | Estimated FY'84 Revenue Cost ($ mils.) |
|---|---|---|
| (1) | The general 60% capital gains exclusion (other than for farming timber, coal and iron ore). | $ 14,320 |
| (2) | Step-up of basis on capital gains at death. | $ 3,565 |
| (3) | Deferral of capital gains on home sales and exclusion of gains on sales for those age 55 and over. | 6,525 |
| (4) | Deductibility of property taxes on owner-occupied homes. | 9,535 |
| (5) | Deductibility of other nonbusiness state and local taxes. | 21,770 |
| (6) | Net exclusion of employer share of pension contribution and earnings. | 56,560 |
| (7) | Deductibility of medical expenses. | 2,630 |
| (8) | Deductibility of casualty losses. | 380 |
| (9) | Dividend exclusion. | 435 |
| | | $115,720 |

After these deletions, the "net" tax expenditure budget for individuals for FY84 would be $143.8 billion or 55% of the official list. We emphasize again that many of the remaining items might well be candidates for removal, too, with a more complete analysis.

The deletion of 45% of the tax expenditure budget results in a very significant shift in the distribution of tax expenditures by income class. (See Table II.) This is because most of the deleted items, according to this analysis, were designed primarily to measure income or to counteract some other tax penalty and these provisions primarily affect upper and upper-middle income groups. (One significant exception is the exclusion for employer contributions to private pension plans. The tax benefit distribution of this provision is weighted more to middle and low-middle income groups.)

TABLE 2

Distribution of Net Tax Expenditures and Tax Liability, Ratio of Net Tax Expenditures to Tax Liability by Income Class ($bils., Fiscal 1981)

| Income Class(AGI) | Number of Returns (mils) | Net Tax Expenditures | | Tax Liability | | Ratio: Expenditure to Liability |
|---|---|---|---|---|---|---|
| | | Total | Distribution | Total | Distribution | |
| 0-10 | 36.3 | $10.4 | 12.0% | $ 8.8 | 3.0% | 1.18 |
| 10-15 | 14.2 | 6.2 | 7.2 | 17.7 | 6.1 | .35 |
| 15-20 | 11.0 | 6.2 | 7.2 | 23.4 | 8.0 | .26 |
| 20-30 | 16.3 | 15.6 | 18.0 | 57.1 | 19.6 | .27 |
| 30-50 | 13.4 | 24.1 | 27.8 | 88.2 | 30.2 | .27 |
| 50-100 | 3.4 | 15.0 | 17.3 | 52.6 | 18.0 | .29 |
| 100-200 | .5 | 5.5 | 6.3 | 22.1 | 7.6 | .25 |
| 200+ | .14 | 3.7 | 4.3 | 22.8 | 7.8 | .16 |

Summary Table

| Income Class(AGI) | Number of Returns (mils) | Net Tax Expenditures Total | Net Tax Expenditures Distribution | Tax Liability Total | Tax Liability Distribution | Ratio: Expenditure to Liability |
|---|---|---|---|---|---|---|
| 0-20 | 61.5 | $22.8 | 26.4% | $ 49.9 | 17.1% | .46 |
| 20-50 | 29.7 | 39.7 | 45.8 | 145.3 | 49.8 | .27 |
| 50+ | 4.04 | 24.2 | 27.9 | 97.5 | 33.4 | .25 |

Source: Office of Tax Analysis, U.S. Department of Treasury and Tax Council computations.

Major differences in the distribution pattern from that of all listed expenditures on page 5 and that for the "net" tax expenditure budget are:

(1) The proportion of tax expenditures accruing to the $50,000 and above income groups drops from 33% to 28%. The proportion for low and low-middle income groups rises from 19% to 26%. The proportion for the broad middle income groups stays about the same.

(2) The ratio of tax expenditures to taxes paid drops from 54% to 25% (for upper income groups). The ratio for other income groups is cut by much lesser amounts. As a result, the distribution pattern of relative benefit -- tax expenditure to taxes paid -- is made almost proportional between the $20,000 and $200,000 income level.

## Zero Bracket Amount

As indicated earlier, the zero bracket amount (formerly standard deduction) is not considered a tax expenditure in the official list. Basically, the ZBA serves as a simplification measure in lieu of itemized deductions, which, however, are all considered tax expenditures. There is, of course, a separate element of income security in the ZBA as the flat amount exceeds what could be taken as itemized deductions by many taxpayers. Particularly with the personal exemption acting as the floor of income maintenance provision in the tax system, there does not seem to be any logical rationale for the ZBA to be excluded from the tax expenditure budget.

If the ZBA were included in our alternative or "net" tax expenditure budget, a much more radical change in the distribution of tax expenditures would result. As our "net" tax expenditure budget includes only about one-half (55%) of the dollar total of all itemized deductions at 1981 levels, we will adjust and reduce the ZBA by the same proportion in Table 3.

By this calculation, the distribution of tax expenditures becomes much more progressive with low and low-middle income groups getting about 32% of the total and having the highest relative benefit of tax expenditures to taxes paid. Middle and upper-middle income groups would receive 43% of tax expenditures and upper income groups, above $50,000, receive 24%.

TABLE 3

Distribution of Net Tax Expenditures Including Zero Bracket Amount Tax Liability and Ratio of Tax Expenditure to Liability By Income Class ($bils., Fiscal 1981)

| Income Class (AGI) | ZBA Tax Expenditure Component | Net Tax Expenditure With ZBA Total | Net Tax Expenditure With ZBA Distribution | Tax Liability Total | Tax Liability Distribution | Ratio: Expenditure to Liability |
|---|---|---|---|---|---|---|
| 0-10 | $4.5 | $14.9 | 15.3% | $ 8.8 | 3.0% | 1.69 |
| 10-15 | 2.4 | 8.6 | 8.8 | 17.7 | 6.1 | .49 |
| 15-20 | 1.6 | 7.8 | 8.0 | 23.4 | 8.0 | .33 |
| 20-30 | 1.7 | 17.3 | 17.7 | 57.1 | 19.6 | .30 |
| 30-50 | .6 | 24.7 | 25.3 | 88.2 | 30.2 | .28 |
| 50-100 | -- | 15.0 | 15.4 | 52.6 | 18.0 | .29 |
| 100-200 | -- | 5.5 | 5.6 | 22.1 | 7.6 | .25 |
| 200+ | -- | 3.7 | 3.8 | 22.8 | 7.8 | .16 |

Summary Table

| Income Class (AGI) | ZBA Tax Expenditure Component | Net Tax Expenditure With ZBA Total | Net Tax Expenditure With ZBA Distribution | Tax Liability Total | Tax Liability Distribution | Ratio: Expenditure to Liability |
|---|---|---|---|---|---|---|
| 0-20 | $8.5 | $31.3 | 32.1% | $ 49.9 | 17.1% | .63 |
| 20-50 | 2.3 | 42.0 | 43.0 | 145.3 | 49.8 | .29 |
| 50+ | -- | 24.2 | 24.8 | 97.5 | 33.4 | .25 |

Source: Office of Tax Analysis, U.S. Department of Treasury and Tax Council computations.

## Corporate Sector

### Investment Credit

| | Estimated FY'84 Revenue Cost ($ mils.) |
|---|---|
| (1) Investment credit (corporate sector only). | $ 12,315 |

Since its enactment in 1962, the investment tax credit has been increased, decreased, repealed, reinstated, made temporary, made permanent, and been allowed to offset 50%, 60%, 70%, 80%, and 90% of tax liability. 1982 law sets the offset at 85% and requires that half the credits value must be deducted from the corresponding cost basis.

Two important legislative developments make questionable the inclusion of the general investment credit as a tax expenditure item. First, when Congress enacted the landmark 1964 tax reduction, it reduced individual tax rates by much more (an average of 20%) than it did corporate rates, (8%). The rationale then was that the business sector had already obtained a large measure of tax relief through guideline depreciation and the investment credit in 1962 (about 80% of the investment credit goes to the corporate sector). Therefore, the credit, in part, was a substitute for more far-reaching corporate rate reduction than actually occurred in 1964 or afterwards.

Secondly, because of past interruptions in the availability of the investment credit, which had a negative effect on business planning for capital spending programs, Congress stated specifically in the 1978 legislation that the 10% credit should be considered a permanent feature of the tax code. Its clear intent to make the credit permanent does not deny the unique nature of the credit and that it is more important to capital-intensive industries. But Congress, at least, does consider the general investment credit to be of sufficient widespread application and success in achieving its objective of encouraging productive investment to be a regular part of the tax structure.

Corporate Rates

| | Estimated FY84 Revenue Cost ($mils.) |
|---|---|
| (2) Reduced tax rates on first $100,000 of corporate income | $ 6,525 |

The purpose of the graduated rate schedule for corporations up to the first $100,000 of corporate income parallels that for the graduated structure for individuals--in this case to shield smaller corporations from the full tax burden. There is no apparent justification for considering the reduced rates for small business as "abnormal" and hence a tax expenditure item while the "normal" marginal rates for individuals are not.

Depreciation

| | Estimated FY84 Revenue Cost ($mils.) |
|---|---|
| (3) Accelerated Cost Recovery System | $ 16,220 |

The tax expenditure element here is said to be the revenue loss associated with the shorter life permitted by ACRS as compared to the guideline lives ascribed in the now defunct Asset Depreciation Range System. In the case of machinery and equipment, however, the use of accelerated methods of depreciation is not a tax expenditure on the ground that these assets do tend to depreciate more rapidly than the simple straight-line calculation might yield. For rental housing and commercial buildings, any depreciation in excess of straight-line is considered a tax expenditure.

Treasury analysts have already recognized the weak case for the tax expenditures arguement and have dropped depreciation from the Special Analysis G listing altogether. The Joint Committee on Taxation retains this item with the caveat that staff is studying its definition particularly in light of the impact of inflation on the eroding real value of depreciation deductions.

The changes enacted through the tax bills of 1981 and 1982 provide the rationale for removing this item from the tax expenditure budget entirely. The notion of useful life for tax depreciation calculations has been rejected outright and replaced with the notion that ACRS, coupled with the investment tax credit, serves as a method to relieve the tax burden on productive capital completely. Congressional Committee prints and conference reports repeatedly cite expensing--the immediate write-off of the full cost of capital--as the "norm" for the treatment of capital for tax purposes. Here is a clear case of measuring real income by correctly identifying business costs.

## Capital Gains

| | Estimate of FY84 Revenue Cost ($mils.) |
|---|---|
| (4) Corporate capital gains (other than farming, timber, iron ore and coal) | $ 2,075 |

The same basic case applies to corporate capital gains as to capital gains of individuals.

## Research and Development

| | Estimated FY84 Revenue Cost ($mils.) |
|---|---|
| (5) Expensing of R&D expenditures | $ 2,370 |
| (6) Suspension of regulations relating to the allocation under Section 861 of research and experimental expenditures | 60 |

As stated above, Congress clearly feels that expensing is the norm for the tax treatment of most productive capital, as it has been for research and development expenditures since 1954.

The inclusion in the tax expenditure list of the revenue loss associated with the suspension of Section 861 regulation governing the allocation of domestic R&D expenses shows the convoluted logic that one must engage in to devise such a list. The U.S. was unique in imposing this allocation requirement on R&D in the first place, and the tax "break" is not a break but a penalty on domestic R&D expenses for certain corporations that happen to find themselves in excess of the foreign tax credit limitation. The suspension of the regulations is not like a statute that creates special tax favor but rather erases a peculiar and damaging tax penalty. Under the logic which places the suspension in the list of current tax expenditures, prior lists should have included as a tax break all domestic R&D expenses that had been allocated abroad but that had not triggered the excess credit limitation.

## Foreign Source Income

| | Estimated FY'84 Revenue Cost ($ mils.) |
|---|---|
| (7) "Deferral" of income of controlled foreign corporations. | $ 345 |

This tax expenditure item probably has produced more argument -- certainly more argument per dollar of estimated revenue cost -- than any of the other 109 separate items. Long a target of the labor movement, tax "deferral" of income of foreign subsidiaries survived several votes in Congress in recent years -- the last of which in 1978 was a quite strong endorsement of the existing treatment.

The tax expenditure element is said to be the interest-free loan that deferral of tax allows to controlled foreign corporations while branches of U.S. companies operating abroad are subject to current taxation. Supporters of the present treatment argue that it is really not a question of "deferral" at all -- that the foreign corporations, whether or not controlled by a U.S. parent, are subject to foreign tax jurisdiction and no matter what the taxation policy of that jurisdiction, no real income for tax purposes is realized by the parent until the earnings are repatriated as dividends. In a series of legislative moves from 1962 through 1976, Congress did carve out so-called "tax haven" or Subpart F income of these subsidiaries and subjected this income to current U.S. taxation. Defenders of the existing treatment would say that Subpart F is the tax abnormality, not the "deferral" system.

The revenue cost of "deferral" is not large in any event. Indeed, some say the Treasury could actually lose revenue if current taxation were forced because foreign countries would retaliate by raising their taxes on U.S. business operations abroad, thereby allowing more foreign tax credits against U.S. tax. The present treatment is considered important, however, by many businesses, particularly those operating in developing countries, as a means of keeping competitive with foreign-owned companies.

### "Net" Level of Corporate Sector Tax Expenditures

The corporate sector tax provisions outlined above add to $39.9 billion as indicated below:

| | | Estimated FY81 Revenue Cost ($ mils.) |
|---|---|---|
| (1) | Investment credit (corporate sector only). | $ 12,315 |
| (2) | Reduced tax rates on first $100,00 of corporate income. | 6,525 |
| (3) | Accelerated Cost Recovery System. | 16,220 |
| (4) | Corporate capital gains (other than farming, timber, iron ore and coal). | 2,075 |
| (5) | Expensing of R&D expenditures. | 2,370 |
| (6) | Section 861. | 60 |
| (7) | "Deferral" of income of controlled foreign corporations. | $ 345 |
| | TOTAL | $ 39,910 |

The FY 1984 tax expenditure budget shows a total of corporate sector tax expenditures at $67.9 billion. Deleting the above leaves a "net" level of $28 billion.

### Conclusion

The foregoing analysis confirms that a principal problem with both the substance and measurement of "tax expenditures" is the ambiguous nature of the definition itself and the apparent arbitrary way in which items are added to or omitted from the tax expenditure list.

The definitional problem lies in a determination of which tax rules are integral to a tax system in order to provide a balanced structure and a proper measurement of net income, and which tax rules represent departures from that net income concept and are simply measures to provide relief, assistance, or incentive for a particular group or activity. It is the tax provisions falling in the second category which most often coincide with the popular conception of "loophole" or special treatment.

Up until the time the tax expenditure concept was introduced in the early 1970s, the rate of inflation had not been such a significant factor in the erosion of real incomes of individuals and businesses. However, since that time the rapidly accelerating inflation rate has led policymakers to realize the importance of considering real (adjusted for inflation) values in making fiscal policy decisions. The present tax expenditure list, however, makes no such recognition.

If there is to be a tax expenditure list, the items included in the Budget's Special Analysis G should be subject to more rigorous analysis by fiscal and tax experts and not just those involved in the budgetary process. One critical benchmark for such an analysis should be whether each item is necessary in order to determine the proper measurement of net income for purposes of taxation.

American Hotel and Motel Association
American Land Development Association
Building Owners and Managers Association, International
Coalition for Low and Moderate Income Housing
Council of State Housing Agencies
International Council of Shopping Centers
Mortgage Bankers Association of America
National Apartment Association
National Association of Home Builders
National Association of Industrial and Office Parks
National Association of Real Estate Companies
National Association of Realtors
National Housing Conference
National Leased Housing Association
National Multi Housing Council
National Parking Association
National Realty Committee

July 25, 1983

Senator Robert Dole
Chairman
Senate Finance Committee
SD-219 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Senator Dole:

The seventeen undersigned organizations, which represent broad segments of the residential, commercial, recreational and industrial real estate industry and the retail sales industry, urge you to oppose any effort to modify the treatment of new and existing structures under the tax code.

The Congressional Budget Office in a proposed list of "Tax Base Broadening Options" and in recent testimony before the Senate Finance Committee has suggested that the Congress might attempt to meet part of the revenue goals of the congressional budget resolution by extending the recovery period for new and existing structures from 15 to 20 years.

ACRS and the other provisions of ERTA were designed to stimulate investment. Any extension or other change in the recovery period for structures could reduce severely the number of industrial, commercial, retail and residential building projects which are being planned for construction, and could jeopardize economic recovery.

While the new ACRS provisions already have helped to attract new capital to our industry, the Congressional Research Service and others have noted that the effective tax rates for structures are much higher than those for other assets after the passage of ERTA and TEFRA. To lengthen the recovery periods for structures would increase this distortion.

The ACRS provisions contained in ERTA have helped to provide the foundation for a major renewal of business activity in this country. They have provided a valuable incentive to new business investment and have demonstrated a commitment to encouraging long-term economic planning. It would be a step backward to impose the disincentives to investment in new and existing structures which have been suggested by the CBO and which would result in adverse changes in the treatment of cost recovery for structures.

We cannot emphasize too strongly our opposition to any changes in the provisions of the tax code affecting new or existing structures, and we urge you to oppose the inclusion of any such changes or restrictions in any tax legislation which may come before the Congress.

Should you wish to discuss in greater detail the concerns we have with the proposals which are reported to be under discussion, please contact Edward C. Maeder at 2550 M Street, N.W., Suite 500, Washington, D.C. 20037, (202)828-8417, or Gil Thurm at 777 14th Street, N.W., Washington, D.C. 20005, (202)383-1083.

Thank you for your consideration.

Sincerely,

American Hotel and Motel Association

American Land Development Association

Building Owners and Managers Association, International

Coalition for Low and Moderate Income Housing

Council of State Housing Agencies

International Council of Shopping Centers

Mortgage Bankers Association of America

National Apartment Association

National Association of Home Builders

National Association of Industrial and Office Parks

National Association of Real Estate Companies

National Association of Realtors

National Housing Conference

National Leased Housing Association

National Multi Housing Council

National Parking Association

National Realty Committee